[JOINT COMMITTEE PRINT]

DESCRIPTION OF THE TECHNICAL CORRECTIONS ACT OF 1987
(H.R. 2636 and S. 1350)

PREPARED BY THE STAFF

OF THE

JOINT COMMITTEE ON TAXATION

JUNE 15, 1987

U.S. GOVERNMENT PRINTING OFFICE
73-917 WASHINGTON : 1987 JCS-15-87

For sale by the Superintendent of Documents, U.S. Government Printing Office
Washington, DC 20402

J862-23

SUMMARY CONTENTS

Page

Introduction xv

Title I. Technical Corrections to the Tax Reform Act of 1986 1

I. INDIVIDUAL INCOME TAX PROVISIONS 1
II. CAPITAL COST PROVISIONS 9
III. CAPITAL GAINS AND LOSSES 19
IV. AGRICULTURE PROVISIONS 21
V. TAX SHELTERS; INTEREST EXPENSE 23
VI. CORPORATE TAX PROVISIONS 28
VII. MINIMUM TAX PROVISIONS 61
VIII. ACCOUNTING PROVISIONS 64
IX. FINANCIAL INSTITUTIONS 74
X. INSURANCE PROVISIONS 78
XI. PENSIONS AND DEFERRED COMPENSATION; EMPLOYEE BENEFITS; ESOPs 86
XII. FOREIGN TAX PROVISIONS 167
XIII. TAX-EXEMPT BOND PROVISIONS 241
XIV. TRUSTS AND ESTATES; MINOR CHILDREN; GENERATION-SKIPPING TRANSFER TAX 257
XV. COMPLIANCE AND TAX ADMINISTRATION PROVISIONS 271
XVI. EXEMPT AND NONPROFIT ORGANIZATIONS 279
XVII. MISCELLANEOUS PROVISIONS 282

Title II. Technical Corrections to Other Tax Legislation 290

A. THE SUPERFUND REVENUE ACT OF 1986 290
B. THE HARBOR MAINTENANCE REVENUE ACT OF 1986 293
C. THE OMNIBUS BUDGET RECONCILIATION ACT OF 1986 295

CONTENTS

Page

Introduction xv

Title I. Technical Corrections to the Tax Reform Act of 1986 1

I. INDIVIDUAL INCOME TAX PROVISIONS (SECTION 101 OF THE BILL) 1

1. Rate of tax with respect to certain unclaimed cash 1
2. Rate of accumulated earnings tax 1
3. Standard deduction and filing requirement for elderly or blind dependents 2
4. Rule for inflation adjustments to earned income credit 3
5. Cross-references to scholarship exclusion provisions in private foundation rules 3
6. Treatment of certain scholarship or fellowship grants to nonresident aliens 4
7. Coordination of two-percent floor and certain other deduction limitation provisions 5
8. Application of two-percent floor to trusts and estates 6
9. Clarification of exceptions to certain rules limiting meal and entertainment deductions 7
10. Carryover of excess home office deductions 8

II. CAPITAL COST PROVISIONS (SECTION 102 OF THE BILL) 9

A. Depreciation and Regular Investment Tax Credit 9
   1. Depreciation 9
   2. Investment tax credit 12
B. Rapid Amortization Provisions 14
   1. Trademark and trade name expenditures 14
   2. Railroad grading or tunnel bores 14
C. Real Estate Provisions 14
   1. Tax credit for rehabilitation expenditures 14
   2. Tax credit for low-income rental housing 15

III. CAPITAL GAINS AND LOSSES (SECTION 103 OF THE BILL) 19

1. Individual and corporate capital gains 19
2. Incentive stock options 19

Page

IV. Agriculture Provisions (Section 104 of the Bill) 21

1. Treatment of discharge of indebtedness income of certain farmers 21
2. Retention of capital gains treatment for sales of dairy cattle under milk production termination program 21

V. Tax Shelters; Interest Expense (Section 105 of the Bill) 23

1. Passive loss rules 23
2. Investment interest limitation 25
3. Personal interest limitation 26

VI. Corporate Tax Provisions (Section 106 of the Bill) 28

A. Corporate Tax Rate 28
B. Dividends Received Deduction: Certain Dividends Received from a Foreign Sales Corporation 28
C. Extraordinary Dividends Received by Corporate Shareholders 29
D. Special Limitations On Net Operating Loss and Other Carryforwards 32
   1. Value of loss corporation: special rule in the case of redemption 32
   2. Definition of ownership charge: owner shift involving five-percent shareholder and equity structure change 32
   3. Special rules for built-in gains and losses and section 338 gains 33
   4. Testing period: shorter period where all losses arise after three-year period begins 34
   5. Definitions of loss corporation, old loss corporation, and new loss corporation 35
   6. Operating rules relating to ownership of stock 36
   7. Bankruptcy proceedings 37
   8. Effective dates 38
E. Recognition of Gain or Loss on Liquidating Sales and Distributions of Property *(General Utilities)*. 40
   1. Limitations on recognition of loss 40
   2. Election to treat certain stock sales and distributions as asset transfers 41
   3. Treatment of distributing corporation where the 80-percent distributee is a tax-exempt organization 42
   4. Basis adjustment in a taxable section 332 liquidation 42
   5. Use of installment method by shareholders in certain liquidations 43
   6. Certain distributions of partnership or trust interests 43

Page

7. Losses on transactions between related parties 44
8. Distributions of property to corporate shareholders 44
9. Certain transfers to foreign corporations 45
10. Gain from certain sales or exchanges of stock in certain foreign corporations 45
11. Tax imposed on certain built-in gains on S corporations 47
12. Regulatory authority to prevent circumvention of provisions 48
13. Transition provisions 48
    a. Built-in gains of S corporations 48
    b. General transition rule based on pre-August 1, 1986 action 49
    c. Transitional rules for certain small corporations 49
    d. Other transitional rules 52

F. Allocation of Purchase Price in Certain Sales of Assets 53
G. Related Party Sales 53
H. Amortizable Bond Premium 54
I. Certain Entity Not Taxed as a Corporation 54
J. Regulated Investment Companies 55
K. Real Estate Investment Trusts 56
L. Real Estate Mortgage Investment Conduits 57

VII. MINIMUM TAX PROVISIONS (SECTION 107 OF THE BILL) 61

VIII. ACCOUNTING PROVISIONS (SECTION 108 OF THE BILL) 64

1. Limitation on the use of the cash method of accounting 64
2. Capitalization rules for inventory, construction, and development costs 66
3. Long-term contracts 68
4. Taxable years of certain entities 69
5. Treatment of installment obligations 71
6. Income attributable to utility services 73

IX. FINANCIAL INSTITUTIONS (SECTION 109 OF THE BILL) 74

1. Limitations on bad debt reserves 74
2. Interest on debt used to purchase or carry tax-exempt obligations 75

X. INSURANCE PROVISIONS (SECTIONS 110 AND 118(g) AND (i) OF THE BILL) 78

1. Treatment of certain market discount bonds. 78
2. Status of certain organizations providing commercial-type insurance 78
3. Inclusion in income of 20-percent of unearned premium reserve 79

Page

4. Treatment of certain dividends and tax-exempt interest 80
5. Loss reserves 81
6. Election to be taxed only on investment income 82
7. Treatment of physicians' and surgeons' mutual protection associations 82
8. Special rule for mutual life insurance company 83
9. Annuity diversification requirements 83
10. Treatment of alternative minimum tax with respect to shareholder surplus account 84
11. Treatment of certain items as not interest for source rules 84
12. Technical corrections to the Deficit Reduction Act of 1984 85

XI. PENSIONS AND DEFERRED COMPENSATION; EMPLOYEE BENEFITS; ESOPS (SECS. 111, 111A, 111B, AND 118(q) OF THE BILL) 86

A. Limitations on Treatment of Tax-Favored Savings 86
  1. Individual retirement arrangements (IRAs) 86
  2. Qualified cash or deferred arrangements 90
  3. Nondiscrimination requirements for employer matching contributions and employee contributions 95
  4. Unfunded deferred compensation arrangements of State and local governments and tax-exempt employers 98
  5. Deferred annuity contracts 100
  6. Elective contributions under tax-sheltered annuities 101
  7. Special rules for simplified employee pensions 102
B. Nondiscrimination Requirements 105
  1. Minimum coverage requirements 105
  2. Minimum participation rule 105
  3. Vesting standards 109
  4. Application of nondiscrimination rules to integrated plans 110
  5. Definitions of highly compensated employee and of line of business 111
  6. Definition of compensation 114
C. Treatment of Distributions 116
  1. Uniform minimum distribution rules 116
  2. Tax treatment of distributions 117
  3. Additional income tax on early withdrawals. 120
  4. Transition rule 125
  5. Loans from qualified plans 126
D. Limits on Tax Deferral Under Qualified Plans 127
  1. Overall limits on contributions and benefits under qualified plans 127

Page
2. Deduction limits for qualified plans ... 130
3. Excise tax on reversion of qualified plan assets to employer ... 132
4. Excise tax on excess distributions from qualified retirement plans ... 134
E. Miscellaneous Pension and Deferred Compensation Provisions ... 139
1. Discretionary contribution plans ... 139
2. Time required for plan amendments ... 139
3. Federal Thrift Savings Plan ... 140
4. Effective dates for collectively bargained plans ... 140
F. Employee Benefit Provisions ... 142
1. Nondiscrimination rules for statutory employee benefit plans ... 152
2. Deductibility of health insurance costs of self-employed individuals ... 152
3. Treatment of certain full-time life insurance salespersons ... 153
4. Exclusion of cafeteria plan elective contributions from wages for purposes of employment taxes ... 153
5. Tax treatment of qualified campus lodging ... 153
6. Military fringe benefits ... 154
G. Employee Stock Ownership Plans (ESOPs) ... 156
1. Changes in qualification requirements relating to ESOPs ... 156
2. Estate tax deduction for sales to an ESOP ... 160
3. Partial exclusion of interest earned on ESOP loans ... 161
4. Sales of stock to an ESOP ... 163
5. Dividends paid deduction ... 164
H. Technical Corrections to the Retirement Equity Act of 1984 ... 166

XII. FOREIGN TAX PROVISIONS (SECTION 112 OF THE BILL) ... 167

A. Foreign Tax Credit ... 167
1. Separate application of foreign tax credit provisions to financial services income ... 167
2. Shipping income ... 170
3. Transition rule for high withholding tax interest on qualified loans ... 170
4. Passive income ... 171
5. Separate application of foreign tax credit limitation under the look-through rules ... 172
6. Definition of high withholding tax interest ... 174
7. Deemed-paid credit ... 174
8. Recapture of foreign separate limitation losses ... 175
B. Source Rules ... 177
1. Determination of source in case of sales of personal property ... 177

Page
2. Special rules for exemption from U.S. tax on U.S. source transportation income 182
3. Limitations on special treatment of 80/20 corporations 183
4. Rules for allocation of interest, etc., to foreign source income 185
C. U.S. Taxation of Income Earned Through Foreign Corporations 196
1. Captive insurance companies 196
2. Insurance companies in general 201
3. Withdrawals of qualified shipping reinvestments that pre-Act law excluded from subpart F income 202
4. Definition of related person 203
5. Measurement of earnings and profits 204
6. Effective date of accumulated earnings tax amendments 206
7. Dividends received deduction 206
D. Special Tax Provisions for U.S. Persons 208
1. Effective date of provision governing transfers of intangibles to related parties 208
2. Treatment of certain passive foreign investment companies 209
E. Treatment of Foreign Taxpayers 217
1. Branch profits tax 217
2. Treatment of deferred payments and appreciation arising out of business conducted within the United States 221
3. Withholding tax on amounts paid by partnerships to foreign partners 222
4. Income of foreign governments 225
5. Dual residence companies 226
F. Foreign Currency Exchange Rate Gains and Losses 227
1. Foreign currency translation 227
2. Foreign currency transactions 228
G. Tax Treatment of Possessions 231
H. Miscellaneous Foreign Provisions 233
1. Relationship with treaties 233
2. Foreign personal holding companies 236
3. Withholding on pensions, annuities and certain other deferred income 238
4. Information exchange 238
5. Maintaining the source of U.S. source income 239

XIII. TAX-EXEMPT BOND PROVISIONS (SECTION 113 OF THE BILL) 241

1. Qualified small-issue bonds 241
2. Student loan bonds 243
3. Qualified 501(c)(3) bonds 243
4. Mortgage revenue bonds and mortgage credit certificates 244

Page
5. Private activity bond volume limitation 244
6. Public approval requirement for private activity bonds 245
7. Limitation on bond-financing of issuance costs 245
8. Arbitrage rebate requirement 246
9. Prohibition of Federal guarantees 249
10. Change in use rules 249
11. Bonds issued by volunteer fire departments .. 250
12. Bonds issued under certain State programs ... 250
13. Effective dates 251
14. Transitional exceptions 252

XIV. TRUSTS AND ESTATES; MINOR CHILDREN; GENERATION-SKIPPING TRANSFER TAX (SECTION 114 OF THE BILL) .. 257

A. Income Taxation of Trusts and Estates 257
1. Grantor treated as holding any power or interest of grantor's spouse 257
2. Limitations to revisionary interest rule exceptions 257
3. Taxable year of trusts 258
4. Estimated taxes of trusts and estates 258

B. Taxation of Unearned Income of Minor Children .. 259

C. Generation-Skipping Transfer Tax 261
1. Overlap of direct skips and taxable termination and distributions 261
2. Treatment of charitable interests 261
3. Special rule for determination of inclusion ratio where inter vivos transfers are includible in transferor's gross estate 262
4. Definition of skip person involving trusts 263
5. Disregard of support obligations as an interest 264
6. Taxation of multiple skips 264
7. Certain interests disregarded 265
8. Definition of transferor 265
9. Regulatory authority to prescribe rules dealing with trust equivalents 266
10. Clarification of inclusion ratio where all transfers to a generation-skipping trust qualify for the gift tax exclusions 266
11. Generation assignment of governmental entities 267
12. Basis of property after a taxable termination 267
13. Treatment of single trust as multiple trusts .. 268
14. Effective date of revised generation-skipping transfer tax 268
15. $2 million exemption 269

Page

XV. COMPLIANCE AND TAX ADMINISTRATION PROVISIONS (SECTION 115 OF THE BILL) 271

1. Nominee reporting by partnerships 271
2. Negligence and fraud penalties 271
3. Penalty for substantial understatement of tax liability 272
4. Differential interest rate 272
5. Information reporting by brokers 273
6. Information reporting on persons receiving contracts from certain Federal agencies 273
7. Information reporting on royalties 274
8. Estimated tax requirements for tax-exempt organizations 275
9. Awards of attorney's fees in tax cases 275
10. Salary of special trial judges 275
11. Retirement pay of Tax Court judges 275
12. Suspension of statute of limitations during prolonged dispute over third-party records ... 277
13. Rescission of statutory notice of deficiency 277
14. General requirement of return, statement, or list 277
15. Certain refundable credits to be assessed under deficiency procedures 278

XVI. EXEMPT AND NONPROFIT ORGANIZATIONS (SECTION 116 OF THE BILL) 279

1. Title-holding companies 279

XVII. MISCELLANEOUS PROVISIONS (SECTION 118 OF THE BILL) 282

1. Tax-exempt entity leasing; definition of tax-exempt controlled entity 282
2. Accrual of interest on certain short-term obligations 282
3. Earnings and profits 283
4. Treatment of transferor corporation 283
5. Golden parachutes 284
6. Settlement funds 286
7. Treatment of stripped tax-exempt bonds 287
8. Reorganizations of investment companies 288
9. Elimination of duplicative Medicare tax provisions for certain State and local government employees 288

Title II. Technical Corrections to Other Tax Legislation 290

A. THE SUPERFUND REVENUE ACT OF 1986 290
1. Tax on chemical feedstocks 290
2. Broadbase environmental tax 291
3. Leaking Underground Storage Tank Trust Fund 291

Page

B. THE HARBOR MAINTENANCE ACT OF 1986 293
  1. Tax rate for fuel used on inland waterways 293
  2. Exemption from the harbor maintenance tax for cargo transported between U.S. possessions, etc 293

C. THE OMNIBUS BUDGET RECONCILIATION ACT OF 1986 295
  1. Exclusion of discharge of indebtedness income in determining tax-exempt status of mutual or cooperative telephone and electric companies 295
  2. Payment period for excise taxes on imported beverages and tobacco products 296

INTRODUCTION

This pamphlet,[1] prepared by the staff of the Joint Committee on Taxation, provides a description of the provisions of H.R. 2636 and S. 1350 (The Technical Corrections Act of 1987), introduced on June 10, 1987. H.R. 2636 was introduced by House Committee on Ways and Means Chairman Rostenkowski and Congressman Duncan; and S. 1350 was introduced by Senate Committee on Finance Chairman Bentsen and Senator Packwood.

The bills are divided into two titles: Title I provides technical corrections to the Tax Reform Act of 1986 ("Reform Act") (P.L. 99-514); and Title II provides technical corrections to certain other tax legislation—the Superfund Revenue Act of 1986 ("Superfund Revenue Act") (P.L. 99-499), the Harbor Maintenance Revenue Act of 1986 ("Harbor Revenue Act") (P.L. 99-662), and the Omnibus Budget Reconciliation Act of 1986 ("OBRA") (P.L. 99-509). Provisions in the bills for which no descriptions are provided are clerical in nature or are transition rules.

The amendments made by the Technical Corrections Act of 1987 are intended to correct, clarify, or conform various recently enacted tax provisions. Provisions in the bills are generally effective as if included in the original legislation, unless otherwise indicated.

---

[1] This pamphlet may be cited as follows: Joint Committee on Taxation, *Description of the Technical Corrections Act of 1987 (H.R. 2636 and S. 1350)* (JCS-15-87), June 15, 1987.

TITLE I. TECHNICAL CORRECTIONS TO THE TAX REFORM ACT OF 1986

I. Individual Income Tax Provisions (Sec. 101 of the Bill)

1. Rate of tax with respect to certain unclaimed cash (sec. 101(a)(1) of the bill, sec. 101 of the Reform Act, and sec. 6867 of the Code)

Present Law

If the IRS determines that the assessment or collection of tax would be jeopardized by delay, the IRS may use expedited procedures as specified in the Internal Revenue Code (secs. 6851 and 6861). For purposes of these expedited assessment and collection procedures, special rules apply if an individual who is in possession of cash (or cash equivalents) in excess of $10,000 does not claim the cash either as his or as belonging to another identifiable person who acknowledges ownership (sec. 6867).

These rules provide that the cash is presumed to represent gross income of a single individual and that the collection of tax will be jeopardized by delay. Under present law, such income is taxable to the possessor of the unclaimed cash at a 50-percent rate (sec. 6867(b)), i.e., the highest income tax rate imposed by Code section 1 as in effect immediately prior to the rate reductions made by the Act.

Explanation of Provision

The bill provides that the rate of tax applicable with respect to unclaimed amounts of cash described in section 6867 is the highest income tax rate specified in Code section 1. This rate is 38.5 percent for taxable years beginning in 1987 and 28 percent for subsequent years.

2. Rate of accumulated earnings tax (sec. 101(a)(2) of the bill, sec. 101 of the Reform Act, and sec. 531 of the Code)

Present Law

The Act generally reduces the maximum rate of Federal income tax on individuals to 28 percent, effective for taxable years beginning after 1987. As a conforming amendment, the personal holding company tax rate (sec. 541) also is reduced to 28 percent for taxable years beginning after 1987. However, the Act did not reduce the accumulated earnings tax rate (sec. 531), notwithstanding that each of these additional corporate taxes is imposed to prevent taxpayers from using a corporation to avoid income tax on the corporation's shareholders.

Explanation of Provision

The bill provides that the rate of the accumulated earnings tax will be 28 percent, effective for taxable years of the corporation beginning after December 31, 1987. This amendment shall not be treated as a change in tax rates for purposes of Code section 15.

3. Standard deduction and filing requirement for elderly or blind dependents (sec. 101(b) of the bill, sec. 102 of the Reform Act, and secs. 63(c)(5) and 6012(a) of the Code)

Present Law

The Act provides a standard deduction for individuals who do not itemize. Elderly or blind taxpayers who do not itemize are allowed an additional standard deduction amount above the basic standard deduction allowed to all nonitemizers.

The additional standard deduction amount is $600 for an elderly or blind individual who is married (whether filing jointly or separately) or is a surviving spouse; the additional amount is $1,200 for such an individual who is both elderly and blind. An additional standard deduction amount of $750 is allowed for a head of household who is elderly or blind ($1,500, if both), or for a single individual (i.e., an unmarried individual other than a surviving spouse or head of household) who is elderly or blind ($1,500, if both). Thus, for example, in 1987 a single elderly individual may claim a basic standard deduction of $3,000 plus an additional standard deduction of $750, for a total of $3,750.

Under the Act, the standard deduction for an individual who may be claimed as a dependent on another taxpayer's return is limited to the greater of $500 or the amount of the individual's earned income (Code sec. 63(c)(5)). The filing threshold for such an individual is the amount of standard deduction that is allowable (sec. 6012(a)(1)(C)).

Explanation of Provision

The bill modifies the standard deduction limitation imposed under section 63(c)(5) on a taxpayer who may be claimed as a dependent on the return of another taxpayer to apply only with respect to the basic standard deduction; thus, the limitation does not also apply with respect to the additional standard deduction amount allowed to elderly or blind individuals.

Accordingly, an elderly or blind individual who may be claimed as a dependent on another taxpayer's return may claim a basic standard deduction up to the greater of $500 or the amount of earned income, plus the additional standard deduction amount (e.g., $600 for a married taxpayer). Since this additional standard deduction amount is not limited by the amount of the dependent's earned income, it may be applied against any remaining income (earned or unearned) that has not been offset by the allowance of the basic standard deduction as described above.

Section 6012(a)(1)(C)(i), which relates to the filing threshold for certain individual taxpayers, is amended to conform to the modification to section 63(c)(5). Thus, for example, an unmarried elderly individual who may be claimed as a dependent on her daughter's tax return must file a return for 1987 only if the elderly individual either (1) has total gross income exceeding $3,750 or (2) has non-earned income exceeding $1,250.

4. Rule for inflation adjustments to earned income credit (sec. 101(c) of the bill, sec. 111 of the Reform Act, and sec. 32(i) of the Code)

Present Law

The Act modifies the earned income credit to provide for inflation adjustments. An inflation adjustment to the earned income credit is rounded to the nearest multiple of $10 (sec. 32(i)(3)).

Explanation of Provision

Under the bill, the provision relating to rounding of inflation adjustments to the earned income credit applies to the sum of the earned income credit amount (prior to adjustment) plus the inflation adjustment, rather than to the inflation adjustment amount itself. Thus, the statute provides that the dollar amount of the earned income credit after being increased by the inflation adjustment is rounded to the nearest multiple of $10.

5. Cross-references to scholarship exclusion provisions in private foundation rules (sec. 101(d)(1) of the bill, sec. 123 of the Reform Act, and secs. 4945(g)(1) and 4941(d)(2)(G) of the Code)

Present Law

Code section 4945(g)(1) provides that certain scholarship or fellowship grants that are made by private foundations do not constitute taxable expenditures if the grant "is subject to the provisions of section 117(a)." Section 4941(d)(2)(G) provides that certain scholarship or fellowship grants that are made by private foundations to government officials do not constitute acts of self-dealing if the grants "are subject to the provisions of section 117(a)." The Act limits the section 117(a) exclusion for certain scholarship and fellowship grants made to degree candidates to amounts not exceeding the recipient's tuition and course-related expenses, and repeals the prior-law limited exclusion for nondegree candidates.

Explanation of Provision

The bill amends the cross-references in the private foundation provisions cited above to refer to certain scholarship or fellowship grants that would be subject to the provisions of Code section 117(a) as in effect prior to its amendment by the Act. Accordingly, the amendments made by the Act to the section 117(a) exclusion do not treat scholarship or fellowship grants made by a private foundation that would not have triggered section 4945 or 4941 excise taxes under prior law as taxable expenditures or self-dealing acts merely because such grants exceed the amount excludable by degree candidates under section 117 as amended by the Act or merely because such grants (up to the amount excludable under prior law) are made to nondegree candidates.

6. Treatment of certain scholarship or fellowship grants to nonresident aliens (sec. 101(d)(2) of the bill, sec. 123 of the Reform Act, and secs. 1441(b) and 871(c) of the Code)

Present Law

Under present and prior law, Code section 1441(b) provides for a 14-percent withholding rate on amounts received by a nonresident alien who is temporarily present in the United States under an "F" or "J" visa that are "incident to a qualified scholarship to which section 117(a) applies, but only to the extent such amounts are includible in gross income." Under section 871(c), such amounts are subject to U.S. tax on a net income basis.

Under prior law, a nondegree candidate could exclude from gross income under section 117 a limited amount of a scholarship or fellowship granted by an educational institution or other tax-exempt organization described in section 501(c)(3), a foreign government, certain international organizations, or a Federal, State, or local government agency. The prior-law exclusion for a nondegree candidate in any one year could not exceed $300 times the number of months in the year for which the recipient received scholarship or fellowship grant amounts, and no further exclusion was allowed after the nondegree candidate had claimed exclusions for a total of 36 months (i.e., a maximum lifetime exclusion of $10,800). However, this dollar limitation did not apply to that portion of the scholarship or fellowship received by the nondegree candidate for travel, research, clerical help, or equipment.

The Act repeals the limited prior-law exclusion under section 117 for grants received by nondegree candidates. As a result, scholarship or fellowship grants received by nonresident aliens who are nondegree candidates are subject to withholding at a 30-percent rate, and to U.S. tax on a gross income basis, since no amount of such grants is "incident to a qualified scholarship to which section 117(a) applies."

The Act also provides that in the case of a scholarship or fellowship grant received by a degree candidate, an exclusion under section 117 is available only to the extent the individual establishes, in accordance with the conditions of the grant, that the grant was used for (1) tuition and fees required for enrollment or attendance of the student at an educational institution (within the meaning of sec. 170(b)(1)(A)(ii)), and (2) fees, books, supplies, and equipment required for courses of instruction at the educational institution.

Explanation of Provision

The bill provides that withholding at a 14-percent rate applies to amounts received as a scholarship or fellowship for study, training, or research at an educational institution (described in sec. 170(b)(1)(A(ii)) in the United States by a nonresident alien who is not a degree candidate, if the grant is made by the educational institution or any other tax-exempt organization described in section 501(c)(3), a foreign government, certain international organizations, or a Federal, State, or local government agency. Also, such amounts eligible for the 14-percent withholding rate are subject to U.S. tax on a net income basis under section 871(c).

As under present law, withholding at 14 percent and taxation on a net income basis apply to amounts received by a nonresident alien who is a degree candidate that are incident to a qualified scholarship or fellowship to which section 117(a) applies, but only to the extent includible in gross income (e.g., amounts received for room, board, or travel).

The bill applies the above rules to "M" visa holders as well as "F" and "J" visa holders.[1]

7. Coordination of two-percent floor and certain other deduction limitation provisions (sec. 101(f)(1) of the bill, sec. 132 of the Reform Act, and sec. 67 of the Code)

Present Law

Code section 67 provides that miscellaneous itemized deductions (generally, certain unreimbursed employee business expenses and certain items allowable under sec. 212) are deductible by itemizers only to the extent that, in the aggregate, they exceed two percent of the taxpayer's adjusted gross income (AGI). Other limitations also apply to particular items that constitute miscellaneous itemized deductions. For example, the last sentence of section 162(a) limits certain deductions for away-from-home living expenses incurred by Members of Congress to $3,000 per year.

Explanation of Provision

The bill clarifies that the two-percent floor on miscellaneous itemized deductions applies prior to application of the $3,000 limitation on certain deductions for Members' away-from-home living expenses. Thus, for example, a Member with AGI of $100,000 who has $5,000 of away-from-home living expense deductions described in section 162(a) (disregarding the dollar limitation contained therein) would be allowed such deductions in the amount of $3,000.[2]

This clarification is consistent with the general rule under the Act to apply certain deduction limitation provisions in the following order: first, provisions disallowing a percentage of a deduction (e.g., sec. 274(n), generally limiting meal and entertainment deductions to 80 percent of the amount otherwise allowable); second, provisions disallowing a fixed dollar amount of certain deductions (e.g., the two-percent floor on miscellaneous itemized deductions); and third, provisions establishing a deduction ceiling (e.g., the $3,000 limit in the last sentence of sec. 162(a), and certain dollar limitations in sec. 217 on deductions for moving expenses).

---

[1] Similar amendments relating to "M" visa holders are made to Code secs. 3121(b)(19), 3231(e), 3306(c)(19), and 7701(b)(5)(D), and sec. 210(a)(19) of the Social Security Act.

[2] In addition, if a Member has expenses subject to the $3,000 limitation and other miscellaneous itemized deductions, the amounts disallowed by the two-percent floor are disallowed proportionately. For example, assume that a Member with AGI of $100,000 has $5,000 of away-from-home expenses (qualifying for the deduction, disregarding application of the $3,000 limit and the two-percent floor, but after application of the 80-percent rule for meal and entertainment expenses) and $5,000 of other miscellaneous itemized deductions, for a total of $10,000 of potential deductions subject to the two-percent floor. Application of the two-percent floor would limit these deductions to $8,000, and the amount disallowed because of the two-percent floor would be disallowed proportionately. Thus, after application of the two-percent floor, the Member could deduct $4,000 of the away-from-home expenses and $4,000 of the miscellaneous itemized deductions. The former amount (i.e., the away-from-home expenses) is further limited to $3,000 because of the special limitation on deducting Members's expenses in sec. 162(a). Thus, the Member could deduct a total of $7,000 of miscellaneous itemized deductions.

8. Application of two-percent floor to trusts and estates (secs. 101(f)(2), (3), and (4) of the bill, sec. 132 of the Reform Act, and sec. 67 of the Code)

Present Law

Under the Act, miscellaneous itemized deductions (generally, certain unreimbursed employee business expenses and items deductible under sec. 212) are deductible only to the extent that, in the aggregate, they exceed two percent of the taxpayer's adjusted gross income (Code sec. 67). In listing the itemized deductions that are not subject to the new two-percent floor, the Act specifically includes the deduction under section 170 (for charitable contributions by individuals or corporations), but does not include the deduction for estates and trusts under section 642(c) (relating to items paid or permanently set aside for a charitable purpose).

Section 67(e) provides that, for purposes of section 67, the adjusted gross income of an estate or trust is computed in the same manner as for an individual, except that certain costs paid in connection with the administration of the estate or trust are treated as allowable in arriving at adjusted gross income. The provision does not state the treatment, for purposes of section 67, of deductions under sections 651 and 661 (relating to certain amounts distributed by a trust or estate).

Section 67(c) provides that Treasury regulations are to (1) prohibit the indirect deduction through pass-through entities of amounts that are not allowable as a deduction if paid or incurred directly by an individual, and (2) contain such reporting requirements as are necessary to accomplish this object. Such regulatory authority does not, however, apply with respect to estates, trusts, cooperatives, and REITs (real estate investment trusts).

Explanation of Provision

The bill provides that deductions under section 642(c) are not miscellaneous itemized deductions subject to the new two-percent floor.

In addition, the bill provides that the distribution deductions allowable to an estate or trust under sections 651 and 661 are treated as allowable in computing the adjusted gross income of the estate or trust. Similarly, deductions for costs paid or incurred in connection with the administration of an estate or trust, and which would not have been incurred if the property were not held in such trust or estate, are treated as allowable in computing the adjusted gross income of the estate or trust. Thus, deductions under sections 651 and 661, and such administrative costs of an estate or trust, are not limited under the new two-percent floor, and are treated as allowable in arriving at the adjusted gross income of the trust or estate for purposes of section 67.

The bill modifies section 67(c) to provide that the regulatory authority of the Treasury with regard to indirect deductions through pass-through entities shall not, except as provided in regulations, apply to estates and trusts. Under this provision, the Treasury has regulatory authority (for example) to apply the two-percent floor at the beneficiary level, rather than at the entity level, to the extent that income is distributed to beneficiaries. As under the Act, the Treasury's regulatory authority does not apply with respect to cooperatives and REITs.

9. Clarification of exceptions to certain rules limiting meal and entertainment deductions (sec. 101(g) of the bill, sec. 142 of the Reform Act, and secs. 274(k)(2), 274(m)(1), and 274(n)(2) of the Code)

Present Law

Code section 274(k) denies deductions for the expense of any food or beverages unless such expense is not lavish or extravagant under the circumstances, and unless the taxpayer or an employee of the taxpayer (including, for this purpose, certain independent contractors) is present at the furnishing of such food and beverages. Code section 274(n) generally limits the amount otherwise allowable as a deduction for the expense of any food or beverages, or any entertainment expense, to 80 percent of the amount otherwise allowable. Special limitations apply under section 274(m)(1) to deductions for luxury water transportation. However, the above limitations under the Act do not apply to items that are not treated as entertainment expenses for purposes of section 274(a) by reason of certain of the exceptions listed in section 274(e).

Explanation of Provision

The bill clarifies that the exceptions to sections 274(k)(2), 274(m)(1), and 274(n)(2) described by cross-references to certain paragraphs of section 274(e) are not subject to the limitations of sections 274(k)(2), 274(m)(1), or section 274(n)(2), whether or not such items (disregarding sec. 274(e)) would be treated as entertainment expenses for purposes of section 274(a).

The bill also provides that the Treasury has regulatory authority to provide additional exceptions to the taxpayer-presence requirement in section 274(k)(2). For example, an exception could be provided for meal expenses of the taxpayer's spouse and children incurred by them as moving expenses deductible pursuant to section 217, even though the taxpayer travelled separately to the new job location. As a further example, the taxpayer-presence requirement could be waived by Treasury regulations in the situation where a business reimburses away-from-home meal expenses of a job applicant who travels to the business location the night before his or her job interview and has a meal alone in the hotel where he or she is staying.

10. Carryover of excess home office deductions (sec. 101(h) of the bill, sec. 143 of the Reform Act, and sec. 280A(c)(5) of the Code)

Present Law

Section 280A limits certain deductions with respect to business use of a dwelling unit that is used by the taxpayer during the taxable year as a residence. In general, such deductions, if not wholly disallowed, are limited to the amount of certain income from the business in which they arose. Under the Act, deductions that are disallowed by reason of exceeding the amount of such business income may be taken into account as a deduction (allocable to such business use of the dwelling unit) for the succeeding taxable year (sec. 280A(c)(5)).

Explanation of Provision

The bill clarifies that, when a deduction for business use of a dwelling unit is carried forward to a succeeding taxable year by reason of the business income limitation in section 280A(5), such deduction shall continue to be allowable only up to the amount of income from the business in which it arose, whether or not the dwelling unit is used as a residence during such taxable year.

II. Capital Cost Provisions (Sec. 102 of the Bill)

A. Depreciation and Regular Investment Tax Credit

1. Depreciation provisions

a. Effect of depreciation on earnings and profits of foreign corporations (sec. 102(a)(3) of the bill, sec. 201(b) of the Reform Act, and sec. 312(k)(4) of the Code)

Present Law

The Act prescribes an alternative depreciation system to compute the earnings and profits of a corporation.

Explanation of Provision

The bill clarifies that the alternative depreciation system applies to compute the earnings and profits of all foreign corporations.

b. Certain property placed in service in churning transactions (sec. 102(a)(6) of the bill, sec. 201(a) of the Reform Act and sec. 168(f)(5) of the Code)

Present Law

The Act prescribes rules to prevent taxpayers from bringing certain property placed in service after December 31, 1980, under the modified Accelerated Cost Recovery System ("ACRS"), where the result would be to qualify such property for more generous depreciation.

Explanation of Provision

The bill clarifies that the determination of whether property would qualify for more generous depreciation is made by comparing depreciation deductions for the first taxable year (whether a short year or a full year), assuming a half-year convention.

Further, the anti-churning rule is inapplicable to property to which the modified ACRS applied in the hands of the transferor.

Finally, with respect to property that is subject to the anti-churning rule, the transferee is subject to the same depreciation regime that the transferor used. Thus, for property that was placed in service by the transferor before January 1, 1981, the transferee would use pre-1981 depreciation rules. Similarly, for property that was subject to ACRS (before amendment by the Act) in the hands of the transferor, the transferee would use pre-1987 ACRS.

c. Treatment of certain transferees (sec. 102(a)(7) of the bill, sec. 201(a) of the Reform Act, and sec. 168(i)(7) of the Code)

Present Law

In certain cases, the transferee of property is treated as the transferor for purposes of computing depreciation deductions with respect to so much of the basis in the hands of the transferee as does not exceed the adjusted basis in the hands of the transferor.

Explanation of Provision

The bill clarifies that in any case where ACRS, as in effect before enactment of the Act, applied to property in the hands of the transferor, the transferee will use pre-enactment ACRS for purposes of computing depreciation deductions.

The bill clarifies that the "step in the shoes" rule applies to transactions between members of an affiliated group of corporations filing a consolidated return. In addition, the Act was not intended to apply to a mere change in form of ownership not involving a sale or exchange. For example, the change from ownership as tenants-in-common to condominium ownership not involving percentage ownership would not require the owners to begin depreciating the property over a new period.

The bill deletes the exception for transactions to which the anti-churning rule applies.

d. Exception for certain property subject to U.S. tax and used by foreign persons (sec. 102(a)(8) of the bill, sec. 201(a) of the Reform Act, and sec. 168(h)(2)(b) of the Code)

Present Law

The Act provides that modified ACRS is inapplicable to motion picture films, video tapes, and sound recordings. The tax-exempt entity leasing rules contain an exception for foreign persons with respect to this property.

Explanation of Provision

The bill deletes the tax-exempt entity leasing exception for motion picture films, video tapes, and sound recordings. The bill also repeals related rules that applied for purposes of the investment tax credit.

e. Applicable depreciation method (sec. 102(a)(11) of the bill, sec. 201(a) of the Reform Act, and secs. 168(b) and (c) of the Code)

Present Law

The Act permits taxpayers to elect to apply the alternative depreciation system to any class of property for any taxable year. Generally, the alternative depreciation system requires use of the straight-line method over a recovery period equal to property's present class life. For purposes of the depreciation preference under the minimum tax, the cost of property generally is recovered using the 150-percent declining balance method over the present class life.

Explanation of Provision

The bill permits taxpayers to elect to apply the minimum tax depreciation rule—150-percent over present class life—for purposes of the regular tax.

f. Election to expense certain depreciable business assets (sec. 102(b)(1) of the bill, sec. 201(d) of the Reform Act, and sec. 179 of the Code)

Present Law

The Act modified the provision under which a taxpayer can elect to treat the cost of qualifying property as an expense that is not chargeable to capital account. The costs for which the election is made are allowed as a deduction for the taxable year in which the qualifying property is placed in service, subject to a $10,000 limitation each year ($5,000 for a married individual filing a separate return). The amount eligible to be expensed is limited for any taxable year in which the aggregate cost of qualifying property placed in service exceeds $200,000; for every dollar of investment in excess of $200,000, the $10,000 ceiling is reduced by $1. In addition, the amount eligible to be expensed is limited to the taxable income derived from active trades or businesses. Costs that are disallowed because of the limitation based on taxable income are carried forward to the succeeding taxable year.

Explanation of Provision

The bill clarifies that costs that are disallowed because of the limitation based on taxable income can be carried forward to an unlimited number of years. Also, the deduction of costs that are carried forward is limited by the $10,000 ceiling (subject to any reduction due to investments that exceed $200,000) in every taxable year.

g. Effective dates; transitional rules (secs. 102(c) and (d) of the bill and secs. 203 and 204 of the Reform Act)

Present Law

The Act modified ACRS for property placed in service after December 31, 1986. The Act provided an election to apply modified ACRS to certain property placed in service after July 31, 1986. Such an election disqualified property under the investment tax credit transitional rules—discussed below. The Act provides certain exceptions to the general effective date.

Explanation of Provisions

The bill clarifies that the election to apply modified ACRS to property placed in service after July 31, 1986, is unavailable to property that would be subject to the anti-churning rule if such property were placed in service after December 31, 1986. Also, property that would be subject to modified ACRS—but for the application of the effective date or a transitional rule—is taken into account for purposes of determining whether property covered by an election to apply modified ACRS will be subject to the mid-quarter convention.

The bill also clarifies that modified ACRS applies to any real property that was acquired before January 1,1987, and converted from personal use on or after such date to a use for which depreciation is allowable.

For purposes of the general transitional rules, all members of the same affiliated group of corporations (within the meaning of section 1504 of the Code) filing a consolidated return are treated as one taxpayer.

The bill makes other clarifying amendments to transitional rules of more limited application, including—but not limited to—clarifications that (1) the general rule for property financed with tax-exempt bonds does not override more specific transitional rules, and (2) the rule for finance leases of farm equipment incorporates the amendments made by the Tax Reform Act of 1984.

Section 204(a)(5)(T) of the Act was intended to include a third project, the approximate cost of which is $375 million, of which approximately $260 million was spent on off-site construction. As the result of a clerical error, the introduced bills did not include this amendment.

2. Investment tax credit

a. Termination of regular percentage (sec. 102(e) of the bill, sec. 211 of the Reform Act, and sec. 49 of the Code)

Present Law

For purposes of determining the amount of the investment tax credit ("ITC"), the regular percentage does not apply to property placed in service after December 31, 1985, subject to an exception for transition property. A taxpayer is required to reduce the basis of property that qualifies for transition relief ("transition property") by the full amount of ITC earned. Further, the ITCs allowable for transition property for taxable years beginning after June 30, 1987, and carryforwards to the first taxable year beginning after June 30, 1987, is reduced by 35 percent. For taxpayers with a taxable year that straddles July 1, 1987, ITCs are subject to a partial reduction that reflects the appropriate reduction for the portion of the taxable year after that date.[1] In the case of transition property that was subject to a full basis adjustment in respect of ITCs earned but unused, there is no upward basis adjustment if the ITCs are subject to further reduction when carried forward.

---

[1] In the case of a corporation that is included in a consolidated return, the determination of whether the taxable year straddles July 1, 1987, is to be made by reference to the taxable year of the consolidated group, and not by reference to any short taxable year applicable to a corporation that is sold out of the group or a corporation that joins the group.

Explanation of Provision

The bill clarifies that a full basis adjustment is applied only with respect to the portion of an ITC attributable to the regular percentage. Further, if a credit for which a full basis adjustment was required (1) is recaptured, there will be an upward basis adjustment of 100 percent of the recapture amount, or (2) expires at the end of the carryforward period, a deduction will be allowed for 100 percent of the unused credit. Also, in applying the rule that coordinates the election to pass an ITC to a lessee and the basis adjustment, the required income inclusion is equal to 100 percent of the credit allowed to the lessee.

The bill also clarifies that the 35-percent reduction applies to ITC carryforwards used in a taxable year ending after June 30, 1987, irrespective of when the property with respect to which the credit is claimed was placed in service. For taxable years that straddle July 1, 1987, the bill clarifies that the amount added to carryforwards bears the same ratio to the carryforwards from the taxable year (before inclusion of the additional amount) as the reduction of the credit bears to the sum of the current year credit for the taxable year and the carryforwards to the taxable year, less the reduction of the credit under section 49(c)(3).

The bill also makes clarifying amendments to other transition rules of more limited application.

b. Elective 15-year carryback for steel companies and qualified farmers (sec. 102(f) of the bill and secs. 212 and 213 of the Reform Act)

Present Law

Certain steel companies can elect a 15-year carryback of 50 percent of ITC carryforwards in existence as of the beginning of a taxpayer's first taxable year beginning after December 31, 1985.

The amount claimed as a payment against the tax for the first taxable year beginning on or after January 1, 1987 cannot exceed the taxpayer's net tax liability for all taxable years during the carryback period (not including minimum tax liability, and reduced by the sum of certain allowable credits). In the case of an electing corporation that is a member of an affiliated group of corporations that filed a consolidated tax return during any portion of the carryback period, the Act contemplates that the Internal Revenue Service will reduce the administrative burden of complying with this requirement—for example, by permitting the use of pro forma statements.

Explanation of Provisions

The bill provides that rules similar to the rules of section 6425 shall apply to any overpayment resulting from the application of the provision for the elective 15-year carryback. Other conforming and technical changes are made.

B. Rapid Amortization Provisions

1. Trademark and trade name expenditures (sec. 102(i) of the bill, sec. 241 of the Reform Act, and sec. 167 of the Code)

Present Law

The Act repealed the prior law provision that allowed taxpayers to elect to amortize over a period of at least 60 months expenditures for the acquisition, protection, expansion, registration or defense of a trademark or trade name other than an expenditure which was part of the consideration for an existing trademark or tradename.

No amortization or depreciation deduction is intended to be allowed for trademark or trade name expenditures.

Explanation of Provision

The bill clarifies that no depreciation or amortization deduction is allowable for trademark or trade name expenditures.

2. Railroad grading or tunnel bores (sec. 102(i) of the bill, sec. 242 of the Reform Act, and sec. 167 of the Code)

Present Law

The Act repealed the prior law provision which provided an election to amortize the cost of qualified railroad grading and tunnel bores over a 50 year period.

No amortization or depreciation deduction is intended to be allowed for such expenditures.

Explanation of Provision

The bill clarifies that no amortization or depreciation deduction is allowable with respect to railroad grading or tunnel bores.

C. Real Estate Provisions

1. Tax credit for rehabilitation expenditures (sec. 102(k) of the bill and sec. 251 of the Reform Act)

Present Law

The Act modified the rehabilitation credit generally for property placed in service after December 31, 1986. Exceptions were provided under transitional rules.

Explanation of Provisions

The bill clarifies that a rehabilitation need not be completed pursuant to a written contract that was binding on March 1, 1986, under the transitional rule that applies where property was acquired before March 2, 1986, or after that date pursuant to a written binding contract, and either required parts of the Historic Preservation Certification Application were filed, or the lesser of $1 million or five percent of the qualified rehabilitation expenditures were incurred or required to be incurred before that date.

Under a provision included in the capital cost recovery section (discussed above), the bill clarifies that property eligible for a 25-percent credit under a transitional rule is not subject to the full basis adjustment requirement.

The bill also includes amendments with respect to other transitional rules of more limited application.

2. Tax credit for low-income rental housing (sec. 102(l) of the bill, sec. 252 of the Reform Act, and sec. 42 of the Code)

Present Law

The Act provides a tax credit that may be claimed by owners of residential rental property used for low-income housing. The credit is claimed annually, generally for a period of ten years beginning either with the year a building is placed in service or one year thereafter (the credit period). Special rules apply to multiple building projects and for certain subsequent additions to basis.

New construction and rehabilitation expenditures for low-income housing projects placed in service in 1987 are eligible for a maximum nine percent credit, claimed annually for ten years. The acquisition cost of existing buildings and the cost of newly constructed buildings receiving other Federal subsidies (e.g., tax-exempt bond financing) placed in service in 1987 are eligible for a maximum four percent credit, also claimed annually for ten years. For buildings placed in service after 1987, these credit percentages will be adjusted to maintain a present value of 70 percent and 30 percent for the two types of credits, and will be determined monthly for property placed in service in each month.

To qualify, a low-income housing project must satisfy a low-income set-aside requirement of either (1) 20 percent of the units occupied by persons having incomes of 50 percent or less of area median income, or (2) 40 percent of the units occupied by persons having incomes of 60 percent or less of such area income. A special additional requirement applies to projects satisfying a specified rent-skewing requirement.

The credit amount is based on the qualified basis of the housing units serving the low-income tenants. Qualified basis is the portion of the basis of the building (eligible basis) attributable to low-income housing units. Basis of units whose cost is disproportionate to that of the low-income housing units is excluded from eligible basis.

Rents that may be charged families in units on which a credit is claimed may not exceed 30 percent of the applicable income qualifying as "low", adjusted for family size. Section 8 payments are excluded in determining the amount of rent a tenant pays for purposes of this 30-percent limit.

To qualify for the credit, residential rental property must comply continuously with all requirements of the credit throughout a 15-year compliance period,[2] and, in the case of a credit for acquisition, may not have previously been placed in service for at least 10 years (the 10-year rule). A credit allocation from the appropriate State credit authority must be received by the owner of property eligible for the low-income housing tax credit, unless the property is substantially financed with the proceeds of tax-exempt bonds subject to the new private activity bond volume limitation. Allocations are charged against the issuer's credit authority for the year of the allocation. Carryforwards of unused credit authority are not permitted.

---

[2] Failure to satisfy this 15-year compliance period results in recapture of a portion of the credit. (A special rule for determining a disposition is a recapture event applies to projects owned by certain large partnerships.)

Explanation of Provisions

Election to determine credit percentage early

The bill provides that, in addition to the method of determining the credit percentage under present law, for buildings placed in service by a taxpayer after 1987 the taxpayer (with the consent of the housing credit agency) may irrevocably elect to determine the credit percentage applicable to the building in advance of the building's placed-in-service date. Such an election will be binding for Federal income tax purposes on the taxpayer, the credit agency, and all successors in interest. The election must be made at the time a binding commitment is received by the taxpayer from the credit agency as to the housing credit dollar amount to be allocated to the building. In the case of a building financed with the proceeds of tax-exempt bonds for which no allocation from a credit agency is required, the election must be made by the taxpayer at the time the tax-exempt bonds are issued. The election must be filed with the Treasury Department by the fifth day of the month following the date the binding commitment is made or the bonds are issued. This election is applicable to credits attributable to new construction, rehabilitation, and acquisition expenditures.

Determination of gross rent

The bill provides that in determining the gross rent that may be paid by a tenant in a low-income unit, payments of State and local rental assistance programs comparable to section 8 of the United States Housing Act of 1937 are not considered. The bill further provides that this definition of gross rent is used for purposes of determining the rent that may be charged to a low-income tenant when applying the elective deep-rent skewing set-aside requirement for certain projects (*see* sec. 142(d)(4)). (The bill retains the definition of gross rent, which includes all rental assistance payments, used in the determinination of the 3:1 rent skewing test also provided for those projects.)

The bill further provides that if a Federal rental assistance payment is made with respect to a low-income unit and the Federal statute (as in effect on October 22, 1986) governing that assistance payment requires that the gross rent paid by the occupants for that unit increase as the income of the occupants increases and that any such increase in the occupants' gross rent reduce equally the Federal rental assistance payment, then the gross rent paid by the tenant may exceed 30 percent of the applicable income limit to the extent required under the applicable Federal housing program statute.

Special rules for multiple building projects

The bill provides new rules for determining whether a building is part of a qualified low-income housing project in the case of multiple building projects. In such a project, buildings need not meet the minimum low-income set-aside requirement only by reference to the order that the buildings are placed in service. If within 12 months of the placed-in-service date of a prior building the project meets the set-aside requirement with respect to the first building and any subsequent buildings placed in service within the 12-month period, then the first building and included subsequent buildings are part of a qualified low-income project. Subsequent buildings not included in determining whether the project satisfies the set-aside requirement with respect to prior buildings have their own 12-month period before they are required to be included in the set-aside determination for the project.

De minimis exception to disproportionate cost limit

The bill permits a portion of the basis of housing units whose cost is disproportionate to that of the low-income units to be included in eligible basis. Unless otherwise provided by Treasury regulations, to be eligible for this exception, the cost per square foot of the disproportionate unit may not exceed by 15 percent the average cost per square foot of the low-income units. If cost differentials exceed 15 percent, the cost of the entire disproportionate unit must be excluded from eligible basis, as under present law.

The bill further provides that costs with respect to which an election was made by the taxpayer to deduct rehabilitation expenditures under prior law section 167(k) may not be included in eligible basis.

Exceptions to 10-year rule

The bill provides several exceptions to the restriction that buildings eligible for an aquisition credit may not have been previously placed in service within 10 years of the date of acquisition. Under these exceptions, a placement in service is disregarded if it is as a result of (1) death, (2) acquisition by a governmental unit or certain qualified 501(c)(3) or 501(c)(4) organizations whose acquisition of the property was at least 10 years after it was previously placed in service, or (3) a foreclosure occurring at least 10 years after the previous placed-in-service date, provided the property is resold within 12 months of such foreclosure.

Amendments affecting State credit authority

The bill provides that the State low-income housing credit authority must allocate credits to a building in the calendar year it is placed in service, unless (1) credits are allocated as the result of additions to qualified basis or (2) the authority makes a binding commitment no later than the last day of such year to allocate a specified amount of credits to the building in a later year. An allocation in a later calendar year pursuant to a binding commitment is counted against the State's credit authority limitation in such later year. Such later allocation does not defer the start of the credit period or the compliance period.

The bill further provides that, if for reasons unforeseen and beyond the control of the taxpayer which occur after an allocation of credit authority to a building, a building cannot be placed in service in the year for which an allocation was made, then upon approval by the Treasury Department, the credit allocation will be valid for that building if the building is placed in service in the first succeeding year after the year of the original allocation. This provision is effective beginning in 1988.

The bill provides that if a corporation is wholly owned by one or more qualified nonprofit organizations and such corporation materially participates in the development and operation of a qualified low-income project, the qualified nonprofit organization(s) will be treated as materially participating in the development and operation of such project for purposes of this section.

Recapture

The bill makes several modifications to the rules regarding recapture of the credit. First, the bill provides that there will be no recapture for certain *de minimis* changes in the qualified basis by reason of changes in floor space of low-income housing units. Second, for partnerships more than 50 percent of which are owned by 35 or more natural persons or estates, the presence of a corporate partner will not exclude the partnership from a special rule under which recapture is determined at the partnership, rather than the partner, level.

Other amendments

The bill clarifies that, similar to other Federally subsidized loans, the proceeds of an issue of tax-exempt obligations used to finance a building may be excluded from eligible basis and the building will not be treated as federally subsidized.

The bill provides that tax-exempt financing or a below market loan used to provide construction financing for a building will not be treated as a Federal subsidy if such loan is repaid and any underlying obligation (e.g., tax-exempt bond) is redeemed before the building is placed in service.

The bill modifies the at-risk provisions applicable to certain financing from qualified nonprofit organizations in the case of certain federally assisted buildings in which a security interest is not permitted by a Federal agency.

The bill provides certain information reporting requirements on owners of qualified low-income housing projects and imposes a penalty for failure to provide required information.

The bill clarifies that the sunset of credit authority to buildings placed in service after 1990 also applies to buildings financed with the proceeds of tax-exempt bonds not requiring an allocation of credit authority.

The bill provides that credits may not be carried back to taxable years ending before January 1, 1987.

The bill makes clarifying amendments to certain transitional rules of limited application.

The bill also corrects other minor clerical and technical errors.

III. Capital Gains and Losses (Sec. 103 of the Bill)

1. Individual and corporate capital gains (sec. 103(a)-(c) of the bill, secs. 301-311 of the Reform Act, and various secs. of the Code)

Present Law

The Act repealed the prior law capital gains deduction for individuals and repealed the alternative tax rate on capital gains for corporations.

Explanation of Provision

The bill makes several conforming amendments to the repeal of the special capital gains treatment, including amendments relating to the computation of foreign source capital gain net income (sec. 904), the exclusion of capital gains by certain financial institutions in computing bad debt reserves under the taxable income method (sec. 593(b)), and the effective date for certain withholding changes.

The bill also repeals a transitional rule for specified taxpayers.

2. Incentive stock options (sec. 103(d) of the bill, sec. 321 of the Reform Act, and sec. 422A of the Code)

Present Law

Under present law, generally an employee is not taxed on the grant or exercise of an incentive stock option (as defined in section 422A(b)) and the employer is not allowed a deduction when the option is granted or exercised. The Act made several changes in the definition of an incentive stock option, including a change to provide that under the terms of the plan, the aggregate fair market value (at the time of grant of an option) of the stock with respect to which incentive stock options are first exercisable during any calendar year may not exceed $100,000.

Explanation of Provision

The bill provides that an option shall not be treated as an incentive stock option if, at the time the option is granted, the terms of the option provide that it will not be treated as an incentive stock option. Thus, an option that otherwise satsisfies the requirements of section 422A(b) shall not be treated as an incentive stock option if, at the time of grant, the option is designated as not constituting an incentive stock option. In the case of an option granted after December 31, 1986, and before the date of enactment of this bill, an option will not be treated as an incentive stock option if the terms of the option are so amended before 90 days after the enactment of this bill.

The bill also deletes the $100,000 requirement added by the Act and instead provides that to the extent the aggregate fair market value (determined at the time the option is granted) of stock with respect to which options meeting the requirements of section 422A(b) are exercisable for the first time by any individual during any calendar year (under all plans of the individual's employer corporation and its parent and subsidiary corporations) exceeds $100,000, then such options shall not be treated as incentive stock options. This rule is applied by taking options that meet the requirements of section 422A(b) and are exercisable for the first time in the calendar year into account in the order granted.

IV. Agriculture Provisions (Sec. 104 of the Bill)

1. Treatment of discharge of indebtedness income of certain farmers (sec. 104(a) of the bill, sec. 405 of the Reform Act, and secs. 108 and 1017 of the Code)

Present Law

Under present law, if an insolvent taxpayer realizes income from discharge of indebtedness, the income is excluded and the taxpayer's tax attributes and basis in property are reduced by the excluded amount (sec. 108). The exclusion is limited to the amount by which the taxpayer is insolvent. Reduction of attributes and basis occurs in the following order: net operating losses and carryovers, general business credit carryovers, capital loss carryovers, basis of property, and foreign tax credit carryovers.[1] The reduction in the basis of property is limited to the excess of the aggregate bases of the taxpayer's property over the taxpayer's aggregate liabilities immediately after the discharge (sec. 1017). If the taxpayer's discharge of indebtedness income (not in excess of the amount by which the taxpayer is insolvent) exceeds the available tax attributes and basis, the excess is forgiven, i.e., is not includible in income.

The Act provides that, in the case of a solvent taxpayer who realizes income from the discharge by a "qualified person" of "qualified farm indebtedness," the discharge is treated in the same manner as if incurred while the taxpayer was insolvent. Qualified farm indebtedness is indebtedness incurred directly in connection with the operation of a farming business by a taxpayer who satisfies a specified gross receipts test. The gross receipts test is satisfied if 50 percent or more of the taxpayer's average annual gross receipts for the three taxable years preceding the taxable year in which the discharged indebtedness occurs is attributable to the trade or business of farming. A qualified person is one regularly engaged in the business of lending money and meeting certain other requirements.

Any amount excluded from income under the special rules for qualified farm indebtedness must be used first to reduce tax attributes; then to reduce basis of property other than land used or held for use in a farming business; and finally to reduce the basis of land used or held for use in a farming business (sec. 1017).

Explanation of Provision

The bill clarifies that, for purposes of determining whether a taxpayer's indebtedness is qualified farm indebtedness, the gross receipts test is applied by dividing the taxpayer's aggregate gross receipts from farming for the three-taxable-year period preceding the taxable year of the discharge by the taxpayer's aggregate gross receipts from all sources for that period. In addition, the term "qualified person" is modified to include a Federal, State, or local government or agency or instrumentality thereof.

---

[1] An election is provided under which the taxpayer may reduce basis in depreciable property before reducing net operating losses or other attributes.

The bill provides that, after reducing tax attributes in the order prescribed for insolvent taxpayers, amounts excluded from income under the qualified farm indebtedness provision may be applied to reduce basis in assets used or held for use in a trade or business or for the production of income (i.e., in "qualified property"). Basis reduction occurs first with respect to depreciable property, then with respect to land used in the business of farming, and then with respect to other qualified property.

The amount excluded under this provision may not exceed the taxpayer's total available attributes and basis in qualified property. Accordingly, to the extent there is unabsorbed discharge of indebtedness income after the taxpayer has reduced tax attributes and basis in qualified property, income will be recognized.

2. Retention of capital gains treatment for sales of dairy cattle under milk production termination program (sec. 104(b) of the bill and sec. 406 of the Reform Act)

Present Law

The Act generally repealed the prior-law deduction for 60 percent of long-term capital gains of noncorporate taxpayers and the alternative tax for long-term capital gains of corporations. However, these amendments made by the Act do not apply to any gain from the sale of dairy cattle under a valid contract with the United States Department of Agriculture under the milk production termination program to the extent such gain is properly taken into account under the taxpayer's method of accounting after January 1, 1987 and before September 1, 1987.

Explanation of Provision

The bill clarifies that the amendments made by the Act with respect to capital gains do not apply to gain properly taken into account under the taxpayer's method of accounting on or after January 1, 1987, and before October 1, 1987, (rather than after January 1, 1987 and before September 1, 1987).

The transition provision applies only to gains that would be capital gains under the generally applicable provisions of the law. See, e.g., IRS Notice 87-26, 1987-10 IRB 16. (February 26, 1987). The transition provision does not recharacterize any payments that would not otherwise be capital gains.

V. Tax Shelters; Interest Expense (Sec. 105 of the Bill)

1. Passive loss rules (sec. 105(a) of the bill, sec. 501 of the Reform Act, and sec. 469 of the Code)

Present Law

Present law, as amended by the Reform Act, provides that deductions from passive trade or business activities, to the extent they exceed income from all such passive activities (exclusive of portfolio income), generally may not be deducted against other income. Similarly, credits from passive activities generally are limited to the tax attributable to the passive activities. Suspended losses and credits are carried forward and treated as deductions and credits from passive activities in the next year. Suspended losses (but not credits) are allowed in full when the taxpayer disposes of his entire interest in the activity to an unrelated party in a transaction in which all realized gain or loss is recognized.

The provision applies to individuals, estates, trusts, and personal service corporations. A special rule prohibits the use of passive activity losses and credits against portfolio income in the case of closely held corporations. Losses and credits attributable to a limited partnership interest generally are treated as arising from a passive activity (except as provided in regulations). Rental activities are defined as passive activities. Special rules provide that up to $25,000 of losses and (deduction equivalent) credits from rental real estate activities (those in which the taxpayer actively participates, with an exception for certain credits) are allowed against other income for the year. Losses from certain working interests in oil and gas property are not limited by the provision. The provision is effective for taxable years beginning after 1986. For certain pre-enactment interests in passive activities, the provision is phased in, and becomes fully effective for taxable years beginning in 1991 and thereafter.

Explanation of Provisions

Definition of portfolio income.—The bill clarifies that income not treated as from a passive activity includes gain or loss that is not derived in the ordinary course of a trade or business, in the case of a disposition of property held for investment or property that generally produces income in the nature of interest, dividends, annuities or royalties. Gain or loss upon disposition of such property, where the gain or loss is derived in the ordinary course of a trade or business, is not automatically treated as not from a passive activity under this rule; rather, the general rules applicable to determining whether an activity is passive (e.g., whether the taxpayer materially participates) apply.

Dispositions.—The bill restates the rules applicable to the allowance of suspended losses upon a disposition of an interest in a passive activity.

In addition, the bill provides that, pursuant to regulations, to the extent necessary to prevent avoidance of the provision, income or gain from a passive activity in taxable years preceding the taxpayer's disposition of the activity is taken into account in determining the amount of the loss allowed against non-passive income upon disposition. Regulatory authority might appropriately be exercised, for example, in situations where passive activities produce taxable passive income in the initial years of an investment and then a loss upon disposition, such as where the investment is structured so that income is recognized in years prior to the allowance of related deductions.

The bill also makes several clerical amendments to the provisions relating to dispositions.

Special rule for rental real estate activities.—The bill clarifies the application of the active participation requirement for the allowance of up to $25,000 of losses (or deduction equivalent credits, where applicable) from certain rental real estate activities. The bill provides that the active participation requirement applies both in the year when the loss arose, and in the year when the loss is allowed under the $25,000 allowance. (The active participation requirement does not apply to low income housing or rehabilitation credits otherwise allowable under the $25,000 allowance.)

The bill also modifies the rule that an interest in an activity as a limited partner is not treated as an interest with respect to which the taxpayer actively participates. Under the bill, this rule applies except as otherwise provided in regulations.

Coordination with rental use of dwelling.—The bill provides that income, deductions, gain or loss from rental use of a dwelling that the taxpayer uses as a residence (or from certain other business uses of a dwelling), for any taxable year in which deductions from such use are limited to the amount of income from such use under Code sec. 280A(c)(5), are not taken into account in determining the taxpayer's passive activity loss for the year. This provision eliminates the partial overlap of the deduction limitations imposed by sec. 280A(c)(5) and by the passive loss rules, principally in the circumstance of rental use of residences, and thus tends to simplify the application of these rules.

Affiliated groups.—The bill clarifies that for purposes of the passive loss rule, all members of an affiliated group that files a consolidated tax return are treated as one corporation, except as otherwise provided in regulations.

Certain installment sales.—The bill treats as income from a passive activity, gain that is recognized in a taxable year beginning after 1986 from the disposition (in a taxable year beginning before 1987) of an interest in an activity that would have been treated as a passive activity within the meaning of sec 469. Thus, under the bill, income from passive activities includes post 1986 gain from the pre-1987 installment sale of an activity that the taxpayer can show would be treated as a passive activity if he had held it in his first taxable year after 1986 (when the passive loss rule applies).

The bill also makes clerical amendments to the definition provisions of the passive loss rule.

2. Investment interest limitation (sec. 105(c) of the bill, sec. 511 of the Reform Act, and sec. 163(d) of the Code)

Present Law

Under present law, in the case of noncorporate taxpayers, the deduction for investment interest expense is limited to the amount of net investment income for the year. Investment interest disallowed for the year is carried forward and treated as investment interest paid or accrued in the succeeding taxable year, and is allowable to the extent the taxpayer has net investment income in such year.

Investment interest is defined to include interest paid or accrued on indebtedness incurred or continued to purchase or carry property held for investment. For this purpose, property held for investment includes an interest in a trade or business activity that is treated as not a passive activity, but in which the taxpayer does not materially participate, within the meaning of the passive loss rule. Investment interest also includes interest expense properly allocable to portfolio income under the passive loss rule. Investment income is defined under present law as gross income from, and gain from the disposition of, property held for investment, to the extent such amounts are not derived from the ordinary conduct of a trade or business.

The provisions of the Reform Act affecting the investment interest limitation are phased in, so that the amended provisions become fully effective for taxable years beginning in 1991 and thereafter.

Explanation of Provisions

Investment interest.—The bill conforms the language of the definition of investment interest to the language of a related provision that allocates interest expense to portfolio income under the passive loss rule. Thus, under the bill, investment interest is that which is properly allocable to property held for investment. This change results in consistency in the language of the provisions allocating interest expense to the category of investment interest, and permits consistent application of a standard for allocation of interest. This change is not intended to suggest the adoption of any particular method of allocation, but rather to give Treasury the ability to devise allocation rules as simple as possible consistent with the objectives of the provision.

Investment income.—The bill conforms the definition of investment income to the definition of investment interest, by deleting the provision that amounts are treated as investment income only to the extent such amounts are not derived from the conduct of a trade or business.

Phase-in rule.—The bill clarifies the operation of the phase-in rule. The bill provides that the amount of current year's investment interest disallowed during any taxable year in the phase-in period shall not exceed the sum of (1) the amount that would be disallowed if: (a) the net investment income were increased by the ceiling amount (generally $10,000), (b) the reduction of net investment income by passive losses allowed under the passive loss phase-in rule did not apply, and (c) an interest in any activity that is not treated as passive and in which the taxpayer does not materially participate were not treated as held for investment; and (2) the applicable percentage for such year (e.g., 35 percent in 1987) of the amount which would be disallowed, under the fully phased-in investment interest limitation, over the amount determined under (1) above.

3. Personal interest limitation (sec. 105(c) of the bill, sec. 511 of the Reform Act, and sec. 163(h) of the Code)

Present Law

Under present law, as amended by the Reform Act, personal interest is not deductible. Personal interest is any interest, other than interest incurred or continued in connection with the conduct of a trade or business (other than the trade or business of performing services as an employee), investment interest, or interest taken into account in computing the taxpayer's income or loss from passive activities for the year.

Present law provides that qualified residence interest is not subject to the limitation on personal interest. Qualified residence interest is interest on debt secured by a security interest valid against a subsequent purchaser on the taxpayer's principal residence or a second residence of the taxpayer. Interest on such debt is deductible to the extent that the debt does not exceed the amount of the taxpayer's basis for the residence (including the cost of home improvements), plus the amount of qualified medical and qualified educational expenses, and to the extent the amount of the debt does not exceed the fair market value of the residence. A grandfather rule is provided in the case of debt incurred on or before August 16, 1986 and secured by the taxpayer's principal or second residence. Interest on such debt (reduced by any principal payments thereon) is generally treated as qualified residence interest, provided the amount of the debt does not exceed the fair market value of the residence. The personal interest limitation is phased in for taxable years beginning after 1986, and becomes fully effective for taxable years beginning in 1991 and thereafter.

Explanation of Provisions

Personal interest.—The bill conforms the language of the definition of personal interest to the language of related provisions (the passive loss rule and the investment interest limitation) under which interest expense may be allocated. Thus, the bill provides that personal interest does not include interest that is properly allocable to a trade or business. This change results in consistency in the language of several significant provisions under which interest is likely to be allocated, and permits consistent application of a standard for allocation of interest.

Refinancing of grandfathered debt.—The bill provides that interest on indebtedness secured by a qualified residence and incurred after August 16, 1986, to refinance grandfathered indebtedness (for example, to obtain a lower interest rate) will be treated as qualified residence interest if certain requirements are met.

Indebtedness secured by the qualified residence and incurred after August 16, 1986 to refinance pre-August 17, 1986 grandfathered indebtedness qualifies under this rule to the extent that the principal amount of the refinancing does not exceed the principal amount of the pre-August 17, 1986 grandfathered indebteness immediately before the refinancing. The refinancing exception will cease to apply, however, after the expiration of the period of the pre-August 17, 1986 indebtedness. Thus, if the pre-August 17, 1986 indebtness was scheduled to be repaid at the end of 1992, interest on any refinancing of that debt, to the extent not otherwise deductible, will not be deductible for any period after 1992. Where the pre-August 17, 1986 debt was not amortized over its term (e.g., a "balloon" note), interest on any otherwise qualified refinancing of that debt will be deductible for the term of the first refinancing of the pre-August 17,1986 indebtedness (but not for more than 30 years after that refinancing). A refinancing of indebtness originally incurred after August 16, 1986 to refinance pre-August 17, 1986 grandfathered indebtedness (e.g., a second refinancing of such pre-August 17, 1986 debt) can also qualify under this rule subject to these requirements.

Thus, under the provision, the current balance (taking into account all amortization of principal) of the debt secured by the taxpayer's residence and incurred on or before August 16, 1986, that was grandfathered under the Reform Act, can be refinanced.

Use of residence.—The bill clarifies the definition of a residence of the taxpayer that is treated as a qualified residence, interest on debt secured by which may be treated as deductible qualified residence interest. Under the bill, a residence may be treated as a qualified residence even if the taxpayer does not use it as such at least 14 days a year or 10 percent of the time it is rented (whichever is greater), provided that the residence is not rented at all during the year.

Unenforceable security interest.—The bill provides that interest on a loan secured by a recorded deed of trust, mortgage, or other security interest in a taxpayer's principal or second residence, in a State such as Texas where such security instrument will be rendered ineffective or the enforceability of such instrument will be otherwise restricted by State and local homestead or other debtor protection law such as the Texas homestead law, shall be treated as qualified residence interest, provided that such interest is otherwise qualified residence interest.

Transfer incident to divorce.—The bill provides that in certain circumstances involving a transfer of a qualified residence between spouses incident to a divorce or legal separation, the basis limitation on debt, interest on which may be deductible, may be increased by the amount of secured indebtedness incurred by a spouse in connection with the acquisition of the other spouse's interest in the residence. The amount of such debt may not, however, exceed the fair market value of the interest in the residence that is being acquired.

In addition, the bill makes several clerical amendments to the personal interest limitation provisions.

VI. Corporate Tax Provisions (Sec. 106 of the Bill)

A. Corporate Tax Rate (sec. 106(a) of the bill, sec. 601 of the Reform Act, and sec. 15 of the Code)

Present Law

The Act revised corporate tax rates, effective for taxable years beginning on or after July 1, 1987. Under the Act, the maximum corporate tax rate under section 11 of the Code for such taxable years is 34 percent (rather than 46 percent, as under prior law). Income in taxable years that include July 1, 1987 (other than as the first date of such year) is subject to a blended rate under the rules specified in section 15 of the Code.

Certain other provisions of the Code require a determination of the maximum corporate tax rate under section 11 for a particular taxable year, for purposes other than imposing a tax by reference to such rate. Such provisions include the "high-taxed income" provisions of sections 904(d)(2)(F) and 954(b)(4) of the Code, which provide special treatment for certain income that is subject to foreign taxes exceeding the highest rate of tax under sections 1 or 11 of the Code (or 90 percent of such rate, in the case of section 954).

Explanation of Provision

The bill clarifies that any reference in the income tax provisons of the Code to the highest rate of tax imposed by section 1 [1] or section 11(b) of the Code (other than a provision imposing a tax by reference to such rate) shall be treated as a reference to the weighted average of the highest rates before and after the change determined on the basis of the respective portions of the taxable year before the date of change and on or after the date of the change. For example, in the case of a calendar year corporate taxpayer, the highest rate under section 11(b) for the calendar year 1987 would be 39.95% (181/365 x 46% and 184/365 x 34%).[2]

B. Dividends Received Deduction: Certain Dividends Received From a Foreign Sales Corporation (sec. 106(b) of the bill, secs. 611 and 612 of the Reform Act, and sec. 245(c) of the Code)

Present Law

The Act reduced to 80 percent the prior law 85 percent deduction that generally applied to dividends received by corporations. The

---

[1] The reference to section 1 of the Code has no application to the non-corporate rate changes imposed by the Act because the Act does not subject the changes under section 1 to section 15 of Code. However, if any future legislation were to impose a rate change under section 1 that is subject to section 15, the provision would apply to such change.

[2] 181 is the number of days in calendar year 1987 prior to July 1; 184 is the number of days in the calendar year 1987 on or after July 1.

Act did not affect the 100 percent dividends received deduction that applies in certain situations.

Under prior law, an 85 percent dividends received deduction was allowed to a domestic corporation for certain dividends attributable to qualified interest and carrying charges received or accrued by the payor corporation while it was a foreign sales corporation (FSC).

Explanation of Provision

The bill conforms the amount of the dividends received deduction for certain dividends attributable to qualified interest and carrying charges received or accrued by the payor corporation while it was a FSC to the general reduction, under the Act, of the 85 percent dividends received deduction to 80 percent. Accordingly, under the bill, the amount of the dividends received deduction for such dividends is reduced to 80 percent.

The bill makes certain other conforming and clerical amendments.

C. Extraordinary Dividends Received by Corporate Shareholders (sec. 106(c) of the bill, sec. 614 of the Reform Act, and sec. 1059 of the Code)

Present Law

Under the Act, if a corporation receives an extraordinary dividend and has not held the stock subject to a risk of loss for a specified holding period (described below), the corporation must reduce its basis in the stock with respect to which the dividend was paid by the nontaxed portion of the dividend (i.e., the portion of the dividend eligible for the dividends received deduction). An extraordinary dividend is generally defined as one exceeding certain "threshold" amounts.

The Act provided a holding period requirement, under which basis reduction is required if the stock is not held subject to a risk of loss for more than two years before the dividend announcement date. The dividend announcement date is defined in the Act as the date on which the corporation declares, announces, or agrees to the payment of the dividend, whichever is the earliest.[3]

The Act also provided that certain distributions are treated as extraordinary dividends without regard to the recipient's holding period or the amount of the dividend. The distributions subject to this rule are any non pro-rata redemption and any redemption in partial liquidation constituting a dividend.

---

[3] Although the amount of any fixed dividend on preferred stock is in a sense "announced" by the terms of the stock at the time the stock is acquired, all such fixed dividends on the stock, however long it is held, are not thus considered to be "announced or agreed to" within the 2-year period. However, the fixed dividends attributable to the first 2 years the preferred stock is held are considered "announced or agreed to" within the first two years, even though a payment date might be missed or there might otherwise be a delay in paying such dividends beyond the first 2 years to which they are attributable.

Similarly, if preferred stock provides for a cumulative dividend of a specified percentage of annual profits, the dividends attributable to the first 2 years profits are subject to the extraordinary dividends rule and basis reduction is required with respect to such dividends if the threshold percentage is exceeded, even if the dividends are not paid until the third year.

The basis reduction rules also apply in other situations that avoid the threshold amount or holding period requirements by deferring or staggering dividend payments.

The Act provided a special relief provision applicable to certain qualifying preferred dividends. Under this provision, certain dividends that would otherwise require basis reduction because the more than two-year holding period is not met, may be eligible for a reduced amount of basis reduction or no basis reduction if the stock is either held for five years or if the dividends received do not exceed the dividends "earned", based on the stock's stated rate of return. This relief provision applies only in the case of certain preferred dividends on stock which provides for fixed dividends payable at least annually, with respect to which the taxpayer's actual rate of return does not exceed 15 percent. Furthermore, relief is available only to the extent the taxpayer's actual rate of return does not exceed the stated rate of return.

The Act provided an exception under which no basis reduction is required in the case of an otherwise extraordinary dividend received with respect to stock of a corporation if: (a) the taxpayer has held the stock during the entire period such corporation was in existence, (b) the only earnings and profits of the corporation were earnings and profits accumulated during such period, and (c) the application of the exception is not inconsistent with the purposes of the extraordinary dividend provision.

The Act also provided an exception under which no basis reduction is required in the case of any qualifying dividend within the meaning of section 243(b)(1) of the Code. This provision was also intended to apply only where earnings and profits would directly or indirectly be solely attributable to the distributee shareholders in the case of distributions that constitute qualifying dividends within the meaning of section 243(b)(1), including such distributions between members of an affiliated group filing a consolidated return. To the extent the consolidated return regulations would require basis reduction in any event, the Act does not simultaneously apply to dividend distributions (or deemed dividend distributions) between members of an affiliated group filing consolidated returns.

Explanation of Provision

The bill clarifies that the dividend announcement date, with respect to which the holding period requirement is tested, is the date on which the corporation declares, announces, or agrees to either the amount or the payment of the dividend, whichever is earliest. Thus, if the amount of a dividend is announced or agreed to within the two-year period, the fact that its payment may not have been announced or agreed to is irrelevant.

The bill clarifies that the nontaxed portion of any dividend that is a non pro-rata distribution or a partial liquidation distribution reduces basis, without regard to whether the two-year holding period requirement has been met.

The bill also clarifies the application of the special exception for dividends on stock that has been held during the entire existence of a corporation. This relief provision was intended to permit distributions without basis reduction, even through the distributions exceed the threshold percentage and are declared, announced or agreed to within the two-year holding period, only in those cases in which the earnings and profits from which the dividend is paid could not have been attributable, directly or indirectly, to any person other than the original shareholder receiving the distribution. For this purpose, earnings and profits are not considered attributable solely to such shareholder if any more than a de minimis part of such earnings and profits is derived, directly or indirectly, from any other entity in which the shareholder was not an original shareholder with an interest at least as great as such shareholder's original and continuing interest in the distributing corporation at the time of the distribution.

Thus, for example, the relief provision does not apply if any more than a de minimis part of the earnings and profits from which the dividend is paid were derived (e.g., by distribution or by a transaction described in sec. 381) directly or indirectly from another corporation in which the original shareholder did not at all times hold at least as great an interest as such shareholder's interest in the distributing corporation at the time of the distribution.

However, the fact that the distributing corporation directly or indirectly received de minimis amounts of earnings and profits from other entities (such as non-extraordinary dividends received from temporary portfolio investments of funds), would not generally be expected to preclude the application of the relief provision.

The bill clarifies that earnings and profits would be indirectly attributable to a person other than the shareholder receiving the distribution if they are attributable to transfers or distributions from any corporation that is not a "qualified corporation". A qualified corporation is one in which the shareholder receiving the dividend holds, directly or indirectly, at least as great an interest, throughout the entire existence of such corporation, as such shareholder has held throughout the period the corporation paying the dividend in question was in existence. In addition, a qualified corporation must have no earnings and profits which were earned by any person, or are attributable to gain on property which accrued during a period in which any person held such property, if the shareholder did not, throughout such corporation's or other person's existence, hold the requisite interest in such corporation or other person.

The bill similarly clarifies the exception for dividends that qualify under section 243(b)(1) of the Code, providing that such dividends do not qualify for the exception to the extent they are attributable to earnings and profits earned by a corporation during a period it was not a member of the affiliated group, or allocable to gain on property which accrued during a period the corporation holding the property was not a member of the affiliated group. It is expected that the application of the provision in the consolidated return context will be consistent with this approach.

The bill clarifies that only fixed dividends (i.e., dividends that do not vary in amount from period to period) are eligible for the special relief provision for qualified preferred dividends.

The bill deletes section 1059(d)(5) of the Code as deadwood.

D. Special Limitations on Net Operating Loss and Other Carryforwards

1. Value of loss corporation: Special rule in the case of redemption (sec. 106(d)(1) of the bill, sec. 621(a) of the Reform Act, and sec. 382(e) of the Code)

Present Law

After a more than 50 percent change in ownership, the taxable income of a loss corporation available for offset by pre-acquisition NOL carryforwards is limited by a prescribed rate times the value of the loss corporation's stock immediately before the ownership change. Debt thus reduces value for purposes of the limitation. Under a special rule, if a redemption occurs in connection with an ownership change—either before or after—the value of the loss corporation's stock is determined after taking the redemption into account. Also, redemptions are taken into account in determining whether a loss corporation has a built-in gain or loss. Further, the Secretary is authorized to prescribe regulations providing for the treatment of corporate contractions as redemptions.

Explanation of Provision

In lieu of regulatory authority, the bill extends the statutory rules for redemptions to other corporate contractions. The rule for redemptions was intended to apply to transactions that effect similar economic results, without regard to formal differences in the structure used or the order of events by which similar consequences are achieved. Thus, for example, the fact that a transaction might not constitute a "redemption" for other tax purposes does not determine the treatment of the transaction under this provision. As one example, a "bootstrap" acquisition, in which aggregate corporate value is directly or indirectly reduced or burdened by debt to provide funds to the old shareholders, is subject to the provision. This includes cases in which debt used to pay the old shareholders remains an obligation of an acquisition corporation or an affiliate, where the acquired loss corporation is directly or indirectly the source of funds for repayment of the obligation.

The bill also clarifies that if the old loss corporation is a foreign corporation, its value shall be determined taking into account only assets and liabilities treated as connected with the conduct of a trade or business in the United States.[4]

2. Definition of ownership change: Owner shift involving five-percent shareholder and equity structure change (sec. 106(d)(2) of the bill, sec. 621(a) of the Reform Act, and sec. 382(g)(4)(C) of the Code)

Present Law

An ownership change occurs if the percentage of stock in a loss corporation owned by one or more five-percent shareholders increases by more than 50 percentage points relative to the lowest percentage of such stock owned by those shareholders during a testing period. The determination whether an ownership change has occurred is made after any owner shift involving a five-percent shareholder or any equity structure shift.

---

[4] This provision relating to foreign corporations applies only to ownership changes occurring after June 10, 1987 (the date of introduction of the bill).

An owner shift involving a five-percent shareholder is defined as any change in the respective ownership of stock in a corporation that affects the percentage of stock held by any person who holds five percent or more of stock in the corporation before or after the change. An equity structure shift is defined as any tax-free reorganization within the meaning of section 368, other than a divisive "D" or "G" reorganization or an "F" reorganization. For purposes of these definitions, all less-than-five-percent shareholders are aggregated and treated as a single five-percent shareholder.

In determining whether an equity structure shift has occurred, the rule that aggregates less-than-five-percent shareholders is applied separately with respect to each group of shareholders of each corporation that is a party to the reorganization ("segregation rule"). Except as provided in regulations, the segregation rule applies in determining whether there has been an owner shift involving a five-percent shareholder; the regulatory authority in section 382(m) augments this rule for cases that involve only a single corporation. To the extent provided in regulations, transactions in which it is feasible to identify changes in ownership involving less-than-five-percent shareholders will be treated under the rules for equity structure shifts.

Explanation of Provision

The bill amends section 382(g)(4)(C) to clarify that rules similar to the segregation rule apply to acquisitions by groups of less-than-five-percent shareholders through corporations as well as other entities (e.g., partnerships), and in transactions that do not constitute equity structure shifts.

The regulatory authority in section 382(g)(3)(B)—to treat transactions under the rules for equity structure shifts—does not limit the scope of section 382(g)(4)(C). Section 382(g)(4)(C), by its terms, generally causes the segregation of the less-than-five-percent shareholders of separate entities where an entity other than a single corporation is involved in a transaction. Section 382(g)(3)(B) merely provides additional authority, as does section 382(m), for cases in which only one corporation is involved.

3. Special rules for built-in gains and losses and section 338 gains (sec. 106(d)(2) of the bill, sec. 621(a) of the Reform Act, and sec. 382(h) of the Code)

Present Law

If a loss corporation has a net unrealized built-in gain, the section 382 limitation for any taxable year ending within a five-year recognition period is increased by the recognized built-in gain for the taxable year. A net unrealized built-in gain is the amount by which the fair market value of a corporation's assets exceeds the aggregate adjusted basis of those assets immediately before an ownership change. The definition of a net unrealized built-in gain is inapplicable unless the amount of net unrealized built-in gain exceeds 25 percent of the value of the corporation's assets. Also, the definition is applied without taking account of any cash, cash items, or marketable security with a value that does not substantially differ from adjusted basis.

The section 382 limitation is increased by the excess of (1) gain recognized by reason of an election under section 338, over (2) the portion of such gain taken into account in computing recognized built-in gains for a taxable year. A recognized built-in gain is any gain recognized during the recognition period on the disposition of any asset, if the corporation establishes that the asset was held immediately before the ownership change, and to the extent the gain does not exceed the excess of the asset's fair market value over the adjusted basis on such date.

If an ownership change occurs during a taxable year, the section 382 limitation does not apply to the utilization of losses against the portion of the corporation's taxable income allocable to the period before the change. For this purpose, except as provided in regulations, taxable income realized during the taxable year is allocated ratably to each day in such year. Under the allocation rule, taxable income is computed without regard to recognized built-in gains and losses.

Explanation of Provision

The bill clarifies that if a section 338 election is made, the section 382 limitation for the taxable year is increased by the lesser of the amount of net unrealized built-in gain (determined as of the time of the section 382 ownership change), not previously recognized, computed without regard to the 25-percent test, or the gain recognized by reason of section 338.

Also, regarding the allocation rule for the taxable year in which an ownership change occurs, taxable income is computed without regard to recognized built-in gain or loss only if the corporation has a net unrealized built-in gain or loss.

4. Testing period: Shorter period where all losses arise after three-year period begins (sec. 106(d)(4) of the bill, sec. 621 of the Reform Act, and sec. 382(i)(3) of the Code)

Present Law

The testing period for determining whether an ownership change has occurred generally is the three-year period preceding any owner shift involving a five-percent shareholder or any equity structure shift. After an ownership change, the testing period does not begin before the day following the first ownership change. If the corporation does not have a net unrealized built-in loss, the testing period does not begin before the first day of the first taxable year from which there is a loss carryforward.

Explanation of Provision

The bill clarifies that the testing period does not begin before the earlier of (1) the first day of the first taxable year from which there is a loss carryforward, or (2) the first day of the taxable year in which the transaction being tested occurs. Thus, where there is a current net operating loss for the taxable year in which an ownership change occurs, the testing period is determined by taking such taxable year into account.

5. Definitions of loss corporation, old loss corporation, and new loss corporation (sec. 106(d)(5) of the bill, sec. 621(a) of the Reform Act, and secs. 382(k) and 382(l)(8) of the Code)

Present Law

The special limitations apply to the taxable income of any "new loss corporation." The term "loss corporation" is defined to include a corporation entitled to use a net operating loss carryover. A "new loss corporation" is a corporation that is a loss corporation after an ownership change. The same corporation may be both the old loss corporation and the new loss corporation.

An "old loss corporation" is a corporation with respect to which there is an ownership change, which was a loss corporation before the ownership change, or with respect to which there is a pre-change loss. A pre-change loss is any net operating loss carryforward of an old loss corporation to the taxable year ending with or in which the ownership change occurs, and the net operating loss of an old loss corporation for the taxable year in which the ownership change occurs (to the extent allocable to the period on or before the change date).

In determining whether an ownership change has occurred, the percentage of stock in the new loss corporation is compared to the lowest percentage of stock in the old loss corporation (or any predecessor) owned by a shareholder during the testing period.

Explanation of Provision

The bill clarifies that the definition of a loss corporation includes a corporation entitled to use a pre-change loss (that is, a net operating loss for the taxable year in which an ownership change occurs, as well as a net operating loss carryover to such year). Thus, for example, the definition of a new loss corporation includes a corporation that is entitled to use a net operating loss that was incurred in the taxable year in which an ownership change occurred.

Except as provided in regulations, any entity and any predecessor or successor of such entity is treated as one entity. As an example, if a corporation purchases 100 percent of the stock of an unrelated loss corporation, the loss corporation would become a new loss corporation. If the new loss corporation liquidates in a tax-free transaction pursuant to sections 332 (so the new loss corporation's net operating loss carryforwards carry over to the acquiring corporation), the acquiring corporation—as successor—will continue to be treated as a new loss corporation.

6. Operating rules relating to ownership of stock (sec. 106(d)(6) of the bill, sec. 621(a) of the Reform Act, and sec. 382(l)(3) of the Code)

Present Law

In determining whether an ownership change has occurred, changes in the holding of certain preferred stock are disregarded, and the constructive ownership rules of section 318 are applied with several modifications.

One modification to the rules of section 318 relates to options and similar interests. Except as provided in regulations, the holder of an option is treated as owning the underlying stock if such presumption would result in an ownership change. Thus, the stock underlying an option or similar interest may be taken into account on and after the date on which the interest is acquired or later transferred. The subsequent exercise of an option is disregarded if the holder of the option has been treated as owning the underlying stock. On the other hand, if the holder of an option was not treated as owning the underlying stock, the subsequent exercise will be taken into account in determining whether there is an owner shift at time of exercise. Similarly, except as provided in regulations, a person is treated as owning stock that may be acquired pursuant to any contingent purchase, warrant, convertible debt, put, stock subject to a risk of forfeiture, contract to acquire stock, or similar interest, if such a presumption results in an ownership change.[5]

The Act does not provide rules for attributing stock that is owned by a government. For example, stock that is owned by a foreign government is not treated as owned by any other person. Thus, if a government of a country owned 100 percent of the stock of a corporation and, within the testing period, sold all of such stock to members of the public who were citizens of the country, an ownership change would result. Governmental units, agencies, and instrumentalities that derive their powers, rights, and duties from the same sovereign authority will be treated as a single shareholder.

Explanation of Provision

The bill clarifies that the constructive ownership rules of section 318 are applied only to "stock" that is taken into account for purposes of section 382. For example, assume a corporation owns both common stock and stock of a type that is not counted in determining whether there has been an ownership change (referred to as "pure preferred") in a holding company. The pure preferred represents 55 percent of the holding company's value. The holding company's only asset consists of 100 percent of the common stock in an operating subsidiary that is a loss corporation. The sale of the pure preferred would not constitute an ownership change because no stock in the loss corporation may be attributed through pure preferred. On the other hand, assume 100 percent of the stock in a loss corporation is transferred in a section 351 exchange, in which the loss corporation's sole shareholder receives pure preferred representing 51 percent of the transferee's value, and an unrelated party receives 100 percent of the transferee's common stock. Here, an ownership change would result with respect to the loss corporation. Similar rules apply where a loss corporation is owned directly or indirectly by a partnership (or other intermediary) that has outstanding ownership interests substantially similar to a pure preferred stock interest.

---

[5] Thus, the type of rights to acquire stock that are subject to the option rule may extend beyond those rights that have been treated as options under section 318(a)(4) as applied for other purposes. For example, a right to acquire unissued stock in a corporation would (except as provided by regulations) be treated as exercised if an ownership change would result, without regard to how such right may have been treated under section 318(a)(4). The Treasury Department will exercise its regulatory authority to prevent the use of the option rule in appropriate cases—as one example, where options or similar interests are issued shortly after a corporation has incurred a de minimis amount of loss.

The bill also clarifies that the rule with respect to options extends beyond options that have been subject to section 318(a)(4).

7. Bankruptcy proceedings (sec. 106(d)(7) of the bill, sec. 621(a) of the Reform Act, and sec. 382(l)(5) of the Code)

Present Law

The special limitations do not apply to an ownership change if the old loss corporation was under the jurisdiction of the court in a title 11 or similar case immediately before the ownership change, and the shareholders and creditors of the old loss corporation own 50 percent or more of the value and voting power of the new loss corporation. A new loss loss corporation may elect to forgo this rule, in which case, the general rules will apply except the value used for purposes of computing the section 382 limitation will be the value of the new loss corporation immediately after the ownership change.

A modified version of the bankruptcy exception applies to a thrift involved in an equity structure shift that is a reorganization described in section 368(a)(3)(D)(ii), or any other equity structure shift or transaction to which section 351 applies that occurs as an integral part of a transaction involving a reorganization described in section 368(a)(3)(D)(ii). The bankruptcy exception is applied to qualified thrift reorganizations by requiring shareholders, creditors, and depositors to retain a 20-percent (rather than 50-percent) interest. For this purpose, the fair market value of the outstanding stock in the new loss corporation includes deposits that become deposits of the new loss corporation.

Explanation of Provision

The bill clarifies that, for purposes of the 50-percent test, stock of a shareholder is taken into account only to the extent such stock was received in exchange for stock or a qualified creditor's interest that was held immediately before the ownership change. Thus, for example, stock received by a former stockholder for new consideration, such as the provision of funds to the corporation, a guarantee of corporate obligations, or any other consideration, is not taken into account. Similarly, stock purchased from other stockholders in the transaction is not counted.

The bill also clarifies that if an election to forgo the bankruptcy rule is made, the value of the new loss corporation will reflect any increase in value resulting from the surrender or cancellation of creditors' claims in the transaction.

Regarding qualified thrift reorganizations, the bill clarifies that the fair market value of the outstanding stock of the new loss corporation includes the amount of deposits in such corporation immediately after the change. Also, it is clarified that the voting power requirement will not cause a failure of the 20-percent test solely because deposits do not carry adequate voting power.

8. Effective dates (sec. 106(d)(10) of the bill and sec. 621(f) of the Reform Act)

Present Law

The provisions of the Act generally apply to ownership changes that occur on or after January 1, 1987. The Act states that its provisions apply to an ownership change following an owner shift involving a five-percent shareholder occurring after December 31, 1986, or following an equity structure shift occurring pursuant to a plan of reorganization adopted after December 31, 1986.

The earliest testing period under the Act begins on May 6, 1986. If an ownership change occurs after May 5, 1986, and before January 1, 1987, and the provisions of the Act do not apply, then the earliest testing period will not begin before the day following the date of such ownership change.

Under the general rules of section 382, if a public offering is performed by an underwriter on a "firm commitment" basis, the underwriter is treated as owning the stock for purposes of determining whether an owner shift involving a 5-percent shareholder has occurred.

The Act contains certain targeted transition provisions.

Explanation of Provisions

The bill clarifies that the provisions of the Act apply to ownership changes occurring after December 31, 1986. For purposes of this transition rule, and for purposes of determining when a new testing period starts under section 382(i), any equity structure shift pursuant to a plan of reorganization adopted before January 1, 1987 is treated as occurring when such plan was adopted.[5a]

By treating equity structure shifts pursuant to plans of reorganization that were adopted before January 1, 1987 as occurring when the plan was adopted, the bill clarifies that no equity structure shift pursuant to a plan adopted after 1986, and no other owner shift involving a 5-percent shareholder occurring after 1986, is protected under the transition provisions, even though such shifts may occur before the completion of a pre-1987 plan of reorganization; i.e., such shifts are not grandfathered by virtue of the pre-1987 plan. If however, an ownership change occurs within the testing period prior to the end of 1987 when any equity structure shift pursuant to a pre-1987 plan is considered together with other pre-1987 owner shifts, that ownership change is grandfathered and a new testing period starts. Any equity structure shift pursuant to a plan adopted after 1986, and any post-1986 owner shift involving a 5-percent shareholder, that occurs before the completion of the pre-1986 plan of reorganization will count for purposes of determining when or whether a later ownership change occurs, under section 382(i).

[5a] The bill thus clarifies that the transition rule for equity structure shifts pursuant to pre-1987 plans of reorganization is applicable even though such equity structure shift may also be an owner shift involving a 5-percent shareholder.

If, applying the foregoing provisions and the rule in section 382(l)(3) (described below), an ownership change occurs immediately following an equity structure shift pursuant to a post-1986 plan of reorganization, or immediately following any other post-1986 owner shift involving a 5-percent shareholder the ownership change is subject to the provisions of section 382 as amended by the Act.

The bill clarifies that the May 6, 1986 testing date applies for purposes of determining whether an ownership change occurred after May 5, 1986 and before January 1, 1987. For purposes of determining whether shifts in ownership occurred between May 5, 1986, and January 1, 1987, the rule in section 382(l)(3) for options and similar interests applies. Thus, in the case of such an interest issued on or after May 6, 1986, and before January 1, 1987, the underlying stock could be treated as acquired at the time the interest was issued. For this transition period, however, in addition to the Treasury Department's general regulatory authority under the rule in section 382(l)(3), the Treasury Department may provide for different treatment in the case of an acquisition of an option or similar interest that is not in fact exercised, as appropriate where the effect of treating the underlying stock as if it were acquired would be to cause an ownership change that would start a new testing period (and thus result in relief under the transitional rules). No inference is intended as to how pre-May 6, 1986 options or similar interests would be treated.

The 1954 Code version of section 382 has continuing application to any increase in percentage points to which the provisions of the Act do not apply by reason of any transitional rule—including the rules prescribing measurement of the testing period by reference only to transactions after May 5, 1986, and the rules that disregard ownership changes following or resulting from certain transactions.

Unless the corporation elects otherwise, an underwriter of an offering for a corporation before September 19, 1986, will not be treated as having acquired stock in the corporation by reason of a firm commitment underwriting, to the extent the stock is disposed of pursuant to the offering, but no later than 60 days after the initial offering.

Any regulations that have the effect of treating a group of shareholders as a separate five-percent shareholder by reason of a public offering will not apply to institutions described in section 591, for any period before January 1, 1989. Further, an underwriter of any offering for such an institution will not be treated as acquiring stock in the institution by reason of a firm commitment underwriting, but only to the extent such stock is disposed of no later than 60 days after the initial offering and pursuant to the offering.

The bill makes certain corrections to specific targeted transition provisions.

E. Recognition of Gain or Loss on Liquidating Sales and Distributions of Property (*General Utilities*)

1. Limitations on recognition of loss (secs. 106(e)(1) and (2) of the bill, sec. 631(a) of the Reform Act, and secs. 336(d)(2) and 336(d)(3) of the Code)

Present Law

A corporation generally recognizes gain or loss on a sale or distribution of property, whether or not in liquidation. However, under the statute, loss is not recognized in certain circumstances (*see, e.g.*, sec. 336(d)).[6] One circumstance in which loss is not recognized involves the sale, exchange or distribution of property acquired by a liquidating corporation in a transaction to which section 351 applied or as a contribution to capital, if the acquisition of such property was part of a plan a principal purpose of which was to recognize loss by the liquidating corporation in connection with the liquidation. In these circumstances, the basis of the property for purposes of determining loss is reduced, but not below zero, by the excess of the adjusted basis of the property on the date of contribution over its fair market value on such date.[7] The statute provides that if the adoption of a plan of complete liquidation occurs in a taxable year following the date on which the tax return including the loss disallowed by this provision is filed, the Secretary may prescribe regulations under which the loss may be recaptured in the year of liquidation, rather than requiring an amended return to be filed with respect to the year the loss was taken. The Act provides that property acquired by the liquidating corporation during the two-year period ending on the date of the adoption of the plan of liquidation shall, except as provided in regulations, be treated as part of such a plan subject to these provisions.[8]

---

[6] Congress did not intend to create any inference regarding the deductibility of losses in liquidating or nonliquidating distributions or sales under other statutory provisions or judicially created doctrines, or to preclude the application of such provisions or doctrines where appropriate See, *e.g.*, sec. 482 and Treas. Reg. sec. 1.482-1(d)(5); *National Securities Corp. Comm'r*, 46 B.T.A. 562 (1942), cert. denied 320 U.S. 794 (1943) (loss on sale by subsidiary of securities transferred by parent in nonrecognition transaction reallocated to parent, where purpose of transfer was to shift unrealized loss on securities to subsidiary); *Court Holding Co.* v. *U.S.*, 324 U.S. 321 (1945) (corporation treated as true seller of property distributed to shareholders and purportedly sold by them to third party); and *Gregory v. Helvering*, 293 U.S. 465 (1935) (in addition to meeting literal requirements of statute, transaction must have valid business purpose to qualify for nonrecognition).

[7] The effect of this rule of section 336(d)(2) is to deny recognition to the liquidating corporation of that portion of the loss on the property that accrued prior to the contribution, but to permit recognition of any loss accruing after the contribution. In the event that a transaction is described both in section 336(d)(1) (which denies loss accruing either before or after the contribution) and section 336(d)(2), section 336(d)(1) will prevail.

This provision was not intended to override section 311(a). Thus, if property is distributed in a nonliquidating context, the entire loss (and not merely the built-in loss) will be disallowed.

[8] Although Congress recognized that a contribution more than two years before the adoption of a plan of liquidation might have been made for such a tax-avoidance purpose, Congress also recognized that the determination that such purpose existed in such circumstances might be difficult for the Internal Revenue Service to establish and therefore as a practical matter might occur infrequently or in relatively unusual cases.

Congress intended that the Treasury Department will issue regulations generally providing that the presumed prohibited purpose for contributions of property within two years of the adoption of a plan of liquidation will be disregarded unless there is no clear and substantial relationship between the contributed property and the conduct of the corporation's current or future business enterprises.

Continued

In the case of any liquidation to which section 332 of the Code applies, the Act provides that no loss shall be recognized in such liquidation.

Explanation of Provision

The bill clarifies that an acquisition of property by a corporation after the date two years before the date the corporation adopts a plan of complete liquidation (rather than merely during the two-year period ending on the date of the adoption of the plan) shall, except as provided in regulations, be treated as acquired as part of a plan a principal purpose of which was to recognize loss by the liquidating corporation in connection with the liquidation.

The bill also clarifies that the provision denying recognition of loss to the distributing corporation in a section 332 liquidation is intended to apply to a distribution to the corporation meeting the control requirement of section 332 only if the distribution does not result in gain recognition to the distributing corporation, pursuant to section 337(a) or (b)(1). Thus, the provision denies loss recognition on a taxable distribution to minority shareholders in such a liquidation. If the section 332 liquidation is not described in section 337(b)(1) or (2) (for example, in the case of certain liquidations into a tax exempt parent corporation) the special loss disallowance provision of section 336(d)(3) does not apply. Such a transaction would be subject to any other applicable loss disallowance provisions, however.

2. Election to treat certain stock sales and distributions as asset transfers (sec. 106(e)(3) of the bill, sec. 631(a) of the Reform Act, and sec. 336(e) of the Code)

Present Law

Under regulations prescribed by the Secretary, a corporation may elect to treat certain sales and distributions of subsidiary stock as asset transfers.

A clear and substantial relationship between the contributed property and the conduct of the corporation's business enterprises would generally include a requirement of a corporate business purpose for placing the property in the particular corporation to which it was contributed, rather than retaining the property outside the corporation. If the contributed property has a built-in loss at the time of contribution that is significant in amount as a proportion of the built-in corporate gain at that time, special scrutiny of the business purposes would be appropriate.

Congress expected that such regulations will permit the allowance of any resulting loss from the disposition of any of the assets of a trade or business (or a line of business) that are contributed to a corporation where prior law would have permitted the allowance of the loss and the clear and substantial relationship test is satisfied. In such circumstances, application of the loss disallowance rule is inappropriate assuming there is a meaningful (i.e., clear and substantial) relationship between the contribution and the utilization of the particular corporation form to conduct a business enterprise. If the contributed business is disposed of immediately after the contribution it is expected that it would be particularly difficult to show that the clear and substantial relationship test was satisfied. Congress also anticipated that the basis adjustment rules will generally not apply to a corporation's acquisition of property as part of its ordinary start-up or expansion of operations during its first two years of existence. However, if a corporation has substantial gain assets during its first two years of operation, a contribution of substantial built-in loss property followed by a sale or liquidation of the corporation would be expected to be closely scrutinized.

Explanation of Provision

The bill clarifies that Congress did not intend to require the election to be made unilaterally by the selling or distributing corporation. The bill thus provides that under regulations prescribed by the Secretary, an election may be made to treat the certain sales and distributions of subsidiary stock as asset sales. Compare section 338(h)(10).

3. Treatment of distributing corporation where the 80-percent distributee is a tax-exempt organization (sec. 106(e)(4) of the bill, sec. 631(a) of the Reform Act, and sec. 337(b)(2) of the Code)

Present Law

Gain or loss is generally not recognized to the distributing corporation on certain distributions to a corporate parent that is an 80-percent distributee. However, if the 80-percent distributee is a tax-exempt organization, this rule does not apply unless the organization uses the property in an unrelated trade or business. Furthermore, if the organization does so use the property but subsequently disposes of the property or otherwise ceases to use it in an unrelated business, such disposition or cessation is a taxable event.

Explanation of Provision

The bill clarifies that the provision with respect to use in an unrelated trade or business was intended to apply to use in an activity the income from which is subject to tax under section 511(a).[9]

4. Basis adjustment in taxable section 332 liquidation (sec. 106(e)(6) of the bill and sec. 334 of the Code)

Present Law

A liquidating corporation recognizes gain or loss on certain liquidating distributions to which the rule of section 332(a) applies— for example, certain distributions to a tax-exempt or a foreign corporation.

Explanation of Provision

The bill clarifies that if gain is recognized on a distribution of property in a liquidation described in section 332(a) to a corporate distributee meeting the stock ownership requirements of section 332(b), a corresponding increase in the distributee's basis occurs.

---

[9] A distribution to a charitable trust would not qualify as a distribution to an 80-percent distributee (since only a corporation can qualify as an 80-percent distributee). Accordingly, the bill deletes the reference to section 511(b)(2) in section 337(b)(2).

5. Use of installment method by shareholders in certain liquidations (sec. 106(e)(6) of the bill, sec. 631(a) of the Reform Act, and sec. 453(h)(1)(B) of the Code)

Present Law

The Act retained prior law in providing that if, in a liquidation to which section 331 applies, the shareholder receives, in exchange for such shareholder's stock, certain installment obligations acquired by the corporation in respect of certain sales or exchanges of property, the receipt of payments under such an obligation by the shareholder shall be treated as the receipt of payment for the stock.

Explanation of Provision

The bill clarifies that, as under the law prior to the enactment of the Act, in the case of inventory the corporate sale or exchange must have been not only to one person but to one person in one transaction.

6. Certain distributions of partnership or trust interests (sec. 106(e)(7) of the bill, sec. 631 of the Reform Act, and secs. 386 and 311 of the Code)

Present Law

Under the Act, a corporation generally recognizes gain or loss on a liquidating distribution of property as if the corporation had sold the property to the distributee. A corporation also generally recognizes gain or loss on liquidating sales of property. Gain but not loss is generally recognized on a nonliquidating distribution. Distributions of partnership interests are thus also treated as sales, invoking the provisions of section 751 of the Code. A separate provision (sec. 386) also provides for the treatment of certain sales and distributions of partnership interests by corporations.

Explanation of Provision

The bill generally repeals section 386 of the Code as deadwood in light of the Act's amendments to sections 311, 336 and 337 of the Code. However, the bill restates, in section 311, the provision contained in present law section 386(d), that the Secretary may by regulations provide that the amount of gain recognized on a nonliquidating distribution of a partnership interest shall be computed without regard to any loss attributable to property contributed to the partnership for the principal purpose of recognizing such loss on the distribution (i.e., thereby reducing the gain otherwise recognized on the distribution and effectively recognizing a loss not permitted in a nonliquidating distribution).[10]

---

[10] This provision is not intended to limit the operation of any present-law step-transaction or other doctrines that would disregard such loss. Such doctrines would also apply if a corporation with property on which loss would be disallowed under other Code provisions (such as sections 336(d)(1) or (d)(2)) contributed such property to a partnership to reduce the gain on distribution of the partnership interest and thus indirectly recognize the loss.

7. Losses on transactions between related taxpayers (sec. 106(e)(8) of the bill, sec. 631 of the Reform Act, and sec. 267 of the Code)

Present Law

No loss is generally allowed with respect to the sale or exchange of property between related taxpayers (other than a loss in case of a distribution in corporate liquidation) (sec.267(a)). The Act provided that certain losses at the corporate level may be denied in a liquidation under other Code provisions (sec. 336(d)).

Explanation of Provision

The bill clarifies that section 267(a) does not apply either to any loss of the distributee or to any loss of the distributing corporation in the case of a distribution in complete liquidation. Losses may be denied under other provisions of law or judicially created doctrine as under present law.

8. Distributions of property to corporate shareholders (secs. 106(e)(9), (10) and (11) of the bill, sec. 631 of the Reform Act, and sec. 301 of the Code)

Present Law

Section 301 of the Code provides generally that, in the case of a corporate distribution of property to a corporate distributee, the amount distributed is the lesser of (1) the fair market value of the property or (2) the adjusted basis of the property in the hands of the distributee, increased in the amount of gain recognized to the distributing corporation on the distribution. The basis of the property in the hands of the distributee is the same as the amount distributed.

If gain is recognized to the distributing corporation on a nonliquidating distribution, the holding period of the property in the hands of the distributee begins on the date of the distribution.

The Act provided that, on a nonliquidating distribution of property to a shareholder (including to a corporate shareholder), gain (but not loss) is recognized to the distributing corporation as if the property had been sold to the distributee at fair market value. On a liquidating distribution, gain or loss is generally recognized (though loss is not recognized in certain instances). Provisions of the Code other than section 301 generally provide for the basis of property received in a liquidation (secs. 331 and 334).

Explanation of Provision

Certain portions of section 301 are repealed as deadwood. Thus, section 301 of the Code is amended to provide that the amount distributed and the basis of property in the hands of a corporate distributee is the fair market value of the property. The holding period of such distributed property in the hands of the distributee begins on the date of the distribution, as under present law, but section 301(e) is not necessary to reach this result and is repealed.

9. Certain transfers to foreign corporations (sec. 106(e)(12) of the bill, sec. 631(d) of the Reform Act, and secs. 367(a) and 367(e)(2) of the Code)

Present Law

Gain is recognized to a liquidating corporation in the case of a liquidating distribution to an 80-percent distributee that is a foreign corporation, unless regulations provide otherwise. It is expected that such regulations may permit nonrecognition if the potential gain on the distributed property at the time of the distribution is not being removed from the U.S. taxing jurisdiction prior to recognition.

Explanation of Provision

The bill clarifies that a tax-free reorganization transfer of property to a foreign corporation is treated in the same manner as a liquidating transfer of such property to an 80-percent foreign corporate distributee. Thus, the provisions of section 367(a)(2) and (3) do not apply, and gain is recognized on a transfer of property described in section 361(a) or (b) (as amended by the bill) by a U.S. corporation to a foreign corporation, unless regulations provide otherwise. However, subject to such basis adjustments as shall be provided in regulations, this rule does not apply if the foreign corporate transferee is 80-percent controlled (within the meaning of section 368(c)) by a domestic corporation or by members of the same affiliated group of corporations within the meaning of section 1504. It is expected that regulations will provide this relief only if the U.S. corporate shareholder agrees to take a basis in the stock it receives in a foreign corporation that is a party to the reorganization equal to the lesser of (a) the U.S. corporation's basis in such stock received pursuant to section 358, or (b) its proportionate share of the basis in the assets of the transferor corporation transferred to the foreign corporation. U.S. taxing jurisdiction over the built-in gain in such cases of U.S. corporate control is indirectly retained through the provisions of the Code relating to controlled foreign corporations. The requirement that certain U.S. corporate shareholders own at least 80 percent of the CFC stock assures that the bulk of the built-in gain will remain subject to U.S. taxing jurisdiction and justifies not imposing a partial tax on the portion of the gain not attributable to U.S. corporate shareholders. (Such a partial tax could present administrative difficulties in adjusting the basis of property in the hands of the transferee foreign corporation.)

10. Gain from certain sales or exchanges of stock in certain foreign corporations (sec. 106(e)(13) of the bill, sec. 631(d) of the Reform Act, and sec. 1248 of the Code)

Present Law

Gain from certain sales or exchanges of stock in certain foreign corporations is characterized as a dividend to the recipient under section 1248 of the Code. Section 1248(f) contains various provisions that under prior law caused income recognition and dividend treatment where a U.S. corporation sold, exchanged, or distributed the stock of a foreign corporation and gain and earnings and profits would not have occurred. This recognition was necessary because prior law treated certain liquidating sales and distributions and certain nonliquidating distributions by corporations as nonrecognition events.

Section 1248(d)(2) also contains a provision that was intended to assure that a foreign corporation that sold property in a liquidation would not experience an increase in earnings and profits to the extent that gain would not be recognized under section 337(a) of the Code on such a sale. This provision was originally written with reference to prior law section 337(a), which was repealed by the Act.

Under the Act, a distributing corporation generally recognizes gain on a liquidating or nonliquidating distribution of property with a fair market value in excess of basis as if the property distributed had been sold to the distributee at fair market value, and earnings and profits of the distributing corporation are accordingly increased. There are certain exceptions in the case of distributions that would be tax-free to a recipient under the tax-free reorganization provisions of the Code or under section 355 of the Code, and in the case of certain liquidating distributions to an 80-percent corporate distributee.

Explanation of Provisions

The bill amends section 1248(f) to conform to the changes under the Act that generally cause gain to be recognized, and earnings and profits to be created, on a liquidating sale or distribution or on a nonliquidating distribution, and that treat liquidating and nonliquidating distributions as sales or exchanges for this purpose. Section 1248(f)(1) under the bill applies only to certain distributions that are still nonrecognition events to the distributing corporation and are not treated as a sale by such corporation to the distributee—that is, distributions that would be tax-free to the recipient under the reorganization provisions of section 361(c) of the Code (as amended by the bill) or under section 355 of the Code and certain liquidating distributions to an 80-percent distributee. As under present law, section 1248(f)(2) excepts those situations in which the recipient U.S. corporation satisfies the stock ownership requirements of section 1248(f)(2) and is treated as holding stock for the period the stock was held by the distributing corporation.

It is contemplated that the Treasury Department may exercise its regulatory authority under section 1248(f) to provide that, in cases where a distribution that would be tax-free but for section 1248(f)(1) occurs within a controlled group, and section 1248(f)(2) does not otherwise apply, the recipient corporation may be required to take a carryover basis in the stock received (rather than a substituted basis under section 358, for example, in the case of a section 355 or 361 distribution) and section 1248(f)(1) will not apply to such distribution.

The bill repeals sections 1248(f)(3) and 1248(d)(2) as deadwood.

The bill makes certain other related clerical and conforming amendments.

11. Tax imposed on certain built-in gains of S corporations (sec. 106(f) of the bill, sec. 632 of the Reform Act, and sec. 1374 of the Code)

Present Law

A corporate level tax is imposed on gain that arose prior to the conversion of a C corporation to an S corporation ("built-in gain") that is recognized by the S corporation through sale, distribution, or other disposition within 10 years after the date on which the S election took effect. The total amount of gain that must be recognized by the corporation, however, is limited to the aggregate net built-in gain of the corporation at the time of conversion to S status.

The Act provided that the amount of recognized built-in gains taken into account for any taxable year shall not exceed the excess (if any) of 1) the net unrealized built-in gain, over 2) the recognized built-in gains for prior years beginning in the 10-year recognition period.

Under the Act, the corporation may take into account certain subchapter C tax attributes in computing the amount of tax on recognized built-in gains. Thus, for example, it may use unexpired net operating losses to offset the gain and may use business credit carryforwards to offset the tax.

Explanation of Provision

The bill clarifies that the built-in gain provision applies not only when a C corporation converts to S status but also in any case in which an S corporation acquires an asset and the basis of such asset in the hands of the S corporation is determined (in whole or in part) by reference to the basis of such asset (or any other property) in the hands of the C corporation. In such cases, each acquisition of assets from a C corporation is subject to a separate determination of the amount of net built-in gain, and is subject to the provision for a separate 10-year recognition period.

The bill clarifies that the amount of recognized built in gains taken into account for any taxable year shall not exceed the excess, if any, of 1) the net unrealized built-in gains at the time of the conversion, over 2) the recognized built-in gains for prior years beginning in the recognition period to the extent such gains were subject to the built-in gains tax.

The bill clarifies that, for purposes of this built-in gains tax under section 1374, any item of income which is properly taken into account for any taxable year in the recognition period but which is attributable to periods before the first taxable year for which the corporation was an S corporation is treated as a recognized built-in gain for the taxable year in which it is properly taken into account. Thus, the term "disposition of any asset" includes not only sales or exchanges but other income recognition events that effectively dispose of or relinquish a taxpayer's right to claim or receive income. For example, the term "disposition of any asset" for purposes of this provision also includes the collection of accounts receivable by a cash method taxpayer and the completion of a long-term contract performed by a taxpayer using the completed contract method of accounting.

The bill clarifies that capital loss carryforwards may also be used to offset recognized built-in gains.

The bill makes certain other clerical and conforming changes.

12. Regulatory authority to prevent circumvention of provisions (sec. 106(e)(5) of the bill, sec. 631 of the Reform Act, and sec. 337(d) of the Code)

Present Law

The Act provided that the Treasury Department shall prescribe such regulations as may be necessary or appropriate to carry out the purposes of the amendments made to Subpart B of the Code under the Act, including regulations to ensure that such purposes may not be circumvented through the use of any provision of law or regulations, including the consolidated return regulations and Part III of the Code, dealing with corporate organizations and tax-free reorganizations.

Explanation of Provision

The bill clarifies that the Treasury Department shall also prescribe such regulations as may be necessary or appropriate to carry out the purposes of the built-in gain provisions, including the use of such pass-through entities, other than S corporations, as regulated investment companies (RICs) or real estate investment trusts (REITs). For example, this includes rules to require the recognition of gain if appreciated property of a C corporation is transferred to a RIC or a REIT in a carryover basis transaction that would otherwise eliminate corporate level tax on the built-in appreciation.

It is expected that Treasury shall also prevent the avoidance of the section through contributions of property with built-in loss to a corporation before it becomes an S corporation.

13. Transition provisions (sec. 106(g) of the bill and sec. 633 of the Reform Act)

a. Built-in gains of S corporations (sec. 106(g)(1) of the bill and sec. 633(b) of the Reform Act)

Present Law

The provisions of the Act (new Code section 1374) that impose a corporate level tax on certain built-in gains of C corporation assets after conversion to S status do not apply unless the first taxable year for which the former C corporation is an S corporation is pursuant to an election made after December 31, 1986. Prior law section 1374 will apply if Code section 1374 as amended by the Act does not apply.

Explanation of Provision

The bill clarifies that, for purposes of the transition provisions, if a corporation was a C corporation at any time prior to December 31, 1986, any "S" status of such corporation prior to its "C" corporation status is disregarded. Thus, the bill provides that (subject to the special small corporation transition rules of the Act) the built-in gains provisions apply to taxable years beginning after December 31, 1986, in cases where the return for the taxable year is filed pursuant to an S election made after December 31, 1986.

The bill clarifies that a 34-percent tax rate applies to capital gain that is subject to prior law section 1374 in taxable years beginning after December 31, 1986.

b. General transition rule based on pre-August 1, 1986 action (sec. 106(g)(2) of the bill and sec. 633(c)(1)(B) of the Reform Act)

Present Law

The statute states that the amendments made by the Act do not apply to distributions or sales or exchanges by a corporation if 50 percent or more of the voting stock by value of such corporation is acquired on or after August 1, 1986, pursuant to a written binding contract in effect before such date and if such corporation is completely liquidated before January 1, 1988. The conference report states that this transition rule applies if "a majority" of the voting stock was acquired pursuant to such binding written contract.

Explanation of Provision

The bill clarifies that the transition rule applies if more than 50 percent (rather than 50 percent or more) of the voting stock is acquired pursuant to the binding written contract.

c. Transitional rules for certain small corporations (secs. 106(g)(3) through 106(g)(8) of the bill and sec. 633(d) of the Reform Act)

Present Law

Special delayed effective dates are provided under the Act for certain closely held corporations that are limited in size. Corporations eligible for this rule are generally entitled to prior-law treatment with respect to liquidating sales and distributions occurring before January 1, 1989, provided the liquidation is completed before that date. However, the special transitional rule requires the recognition of income on distributions of ordinary income property and short-term capital gain property. The statute states that recognition is also required with respect to any gain to the extent section 453B of the Code applies.

The Act provides that a corporation eligible for this rule may also become an S corporation for a taxable year beginning before January 1, 1989. In such a case, the corporation is not subject to the new rules of section 1374 relating to built-in gains except with respect to ordinary income and short-term capital gain property.[11]

---

[11] However, a corporation having a value in excess of $5 million (but not in excess of $10 million) is subject to a phase-out of this relief. Thus, in such circumstances new section 1374 applies to a portion of the long-term capital gain. Section 1374 as in effect before the Act will apply to any portion of the built-in long term capital gains not subject to new section 1374. In addition,

Continued

The Act repealed section 333 of the Code. However, the amendments made by the Act do not apply to the applicable percentage of each gain or loss which would otherwise be recognized by reason of the Act. The applicable percentage is 100 percent if the applicable value of the qualified corporation is less than $5 million, and phases down to 0 percent if the applicable value of the corporation exceeds $10 million.

For distributions prior to January 1, 1989, qualifying corporations continue to be eligible for relief under the rules relating to nonliquidating distributions in effect prior to the Act (prior law sec. 311(d)(2)). However, this relief does not apply to distributions of ordinary income property or short-term capital gain property.

The Act provides that a corporation is eligible for these special delayed effective dates if it was in existence on August 1, 1986, its value does not exceed $10 million, and more than 50 percent (by value) of the stock is held by 10 or fewer qualified persons. The conference report states that such 10 or fewer qualified persons must have held their stock for five years or longer.

The Act provides that a qualified person is an individual, an estate, or any trust described in clause (ii) or (iii) of section 1361(c)(2)(A) of the Code. Specified attribution rules are provided for purposes of determining ownership.

The Act provides that all members of the same controlled group (as defined in section 267(f)(1) of the Code) are treated as one corporation for purposes of the small corporation transitional rules.

The Act provides that the small corporation transition rules shall also apply in the case of a transaction described in section 338 of the Code where the section 338 acquisition date is before January 1, 1989.

Explanation of Provision

The bill clarifies that a qualified corporation eligible for the special delayed effective dates does not recognize gain on a distribution of installment obligations that are received in exchange for long-term capital gain property (including section 1231 property the disposition of which would produce long-term capital gain) where the distribution of such obligations would not have caused corporate level recognition under sections 337 and 453B(d)(2) as in effect prior to the Act. However, distributions of such installment obligations received in exchange for ordinary income property or short-term capital gain property do require the recognition of corporate level gain.

It is intended that a taxpayer that purchases the stock of a qualified corporation in a qualified stock purchase prior to January 1, 1989, is entitled to apply prior-law rules (modified as in the case of actual liquidations) with respect to an election under section 338, even though in the hands of the acquiring corporation the qualified corporation no longer satisfies the stock holding period requirements and may not satisfy the size or shareholder requirements due to the size or shareholders of the acquiring corporation.

---

to the extent a corporation is eligible for relief under the small corporation rule, a portion of any other long-term capital gain that would be covered by prior law section 1374 (whether or not built-in at the time of conversion) continues to be covered by that section.

The bill clarifies that, although the Act repealed section 333 of the Code, in the case of a liquidating distribution to which section 333 of prior law would apply, a shareholder of a qualified corporation electing such treatment is entitled to apply section 333 without any phase-out of shareholder level relief under the Act. However, an increase in shareholder-level gain could result from an increase in corporate earnings and profits resulting from application of the corporate-level phase-out of relief.

The bill clarifies that for distributions before January 1, 1989, qualifying corporations continue to be eligible for relief under prior-law rules relating to nonliquidating distributions with respect to qualified stock, (prior law sec. 311(d)(2)), without regard to whether the corporation liquidates before January 1, 1989. However, this relief does not apply to distributions of ordinary income property or short-term capital gain property.

The bill clarifies that a corporation is not a qualified corporation unless more than 50 percent (by value) of the stock of such corporation is owned (on August 1, 1986 and at all times thereafter before the corporation is completely liquidated) by the same 10 or fewer qualified persons who at all times during the 5-year period ending on the date of the adoption of the plan of liquidation (or, if shorter, the period during which the corporation or any predecessor was in existence) owned (or were treated as owning under the attribution rules) more than 50 percent (by value) of the stock of such corporation.

Where stock passes to an estate, the holding period of the estate includes that of the decedent. Also, the "look-through" attribution rules that apply under this provision do not apply in the case of trusts qualifying under section 1361(c)(2)(ii) or (iii), just as they do not apply under the Act in the case of estates. Thus, stock held by such entities, like stock held by an estate, is to be treated as held by a single qualified person, so that the 10-shareholder test will not cease to be satisfied merely because a decedent's stock passes to such a trust. (In the case of other trusts holding stock, the "look-through" attribution rules apply to determine whether more than 10 qualified persons ultimately own the stock).

The bill also clarifies that the holding period of a decedent's estate (or a section 1361(c)(2)(A)(ii) or (iii) trust) is tacked with that of any beneficiary, as well as with that of the decedent, for purposes of determining the holding period. However, except in the case of beneficiaries who are treated as being "one person" with the decedent, once stock has been distributed to beneficiaries, the 10-shareholder requirement might fail to be satisfied due to an increase in the number of shareholders.

In the case of indirect ownership through an entity, the rules described above are the only rules that apply to determine ownership and holding period. Thus, it is not intended that holding periods could otherwise be "bootstrapped" through analogy to or application of any provision of section 1223. For example, if a partnership owns all the stock of a corporation, a new partner who contributes other property to the partnership in exchange for a partnership interest is deemed under section 1223 to have a holding period in the partnership interest that includes such person's holding period for the property contributed. However, such a person would not be deemed thereby to have owned stock in the corporation that the partnership owned for any period prior to the time the person became a partner. In such cases, under the attribution and other holding period rules of the transitional provision a qualified person's holding period for the underlying stock is the lesser of (1) the period during which the entity held the stock in the qualified corporation, or (2) the period during which the qualified person held the interest in the entity. In other situations, the basic attribution and holding period rules of the transitional rule provision may provide a different result.[12]

The bill clarifies that the rule that all members of a controlled group of corporations (as defined in section 267(f)(1)) are treated as a single corporation applies solely for purposes of determining whether the corporation meets the size requirements for relief. Thus, it is clarified that it is not necessary for all members of a group that, in the aggregate, meets the size requirements for a qualified corporation, to liquidate before January 1, 1989, in order for the liquidation of one member of the group to qualify for relief. It is not intended that an S corporation be included as a member of the group unless such corporation was a C corporation for its taxable year including August 1, 1986 or was an S corporation that was not described in section 1374(c)(1) or (2) of prior law for such taxable year.

The bill also provides a rule to prevent the use of qualified corporations as conduits for the sale of assets by corporations that are not qualified. It is expressly provided that the transition rules do not apply where a principal purpose of a carryover basis transfer of an asset to a qualified corporation is to secure the benefits of the special transition rules. This provision is not intended to limit the application of the step transaction doctrine or other doctrines that would prevent the use of the transition rules. It is expected that a similar step transaction approach would be applied in the case of any transfer of assets to any corporation that qualified for transition under any of the other provisions of the Act, if a principal purpose of the transfer was to secure the benefit of transition for an otherwise non-qualified transaction.

The bill makes certain other clerical and conforming changes.

d. Other transitional rules (secs. 106(g)(9) through 106(g)(12) of the bill and secs. 633(f)(2), (3), (4), and (5) of the Reform Act)

Present Law

The Act provided certain targeted transitional rules.

Explanation of Provision

The bill makes certain corrections to the existing targeted transitional rules.

---

[12] For example, if a qualified person held stock of a corporation and subsequently contributed that stock to a partnership, the person's holding period would include the entire period the stock was held, directly or indirectly.

The bill does not make any statutory change with respect to section 1223 since section 1223 does not by its terms operate to extend attribution periods, as explained above.

F. Allocation of Purchase Price in Certain Sales of Assets (sec. 106(h) of the bill, sec. 641 of the Reform Act, and sec. 1060 of the Code)

Present Law

Under the Act, in the case of an "applicable asset acquisition" both the buyer and the seller must allocate purchase price using the so-called "residual method" of allocation. Thus, both parties must use this method, as described in regulations under section 338 of the Code.[13] An applicable asset acquisition is any transfer of assets constituting a business in which the transferee's basis is determined wholly by reference to the purchase price paid for the assets.[14] Both direct and indirect transfers of a business are covered by this provision, including, for example, a sale of a business by an individual or a partnership, or a sale of a partnership interest in which the basis of the purchasing partner's proportionate share of partnership assets is adjusted to reflect the purchase price.

The Treasury Department is authorized to require information reporting by the parties to an applicable asset acquisition.

Explanation of Provisions

The bill provides that section 1060 applies to a distribution or transfer of an interest in a partnership to which section 755 applies, for purposes of determining the value of goodwill or going concern value (or similar items) under section 755.[15]

The bill provides that any information reporting required by the Treasury Department pursuant to this provision constitutes an information return for purposes of the penalty provisions of the Code.

The bill makes certain other clerical and conforming changes.

G. Related Party Sales (sec. 106(i) of the bill, sec. 642 of the Reform Act, and sec. 453 of the Code)

Present Law

Installment sale treatment is not available for gain on a sale of property to a related party; rather, the seller must include all payments to be received in the year of the disposition. Contingent payments must also be included in the seller's income in the year of disposition. Under the Act, in the rare and extraordinary case in which the fair market value of contingent payments may not be reasonably ascertained, basis shall be recovered ratably. The so-called "open transaction" cost-recovery method of reporting sanctioned in *Burnet* v. *Logan*, 283 U.S. 404 (1931) may not be used.[16]

---

[13] See. Temp. Treas. Reg. sec. 1.338(b)-2T. The Act endorsed the use of the residual method generally and applied the same method regardless of whether a transfer took the form of a stock transfer or an asset transfer. The Act did not preclude the Treasury Department from making changes to the final regulations, not inconsistent with the statutory purpose.

[14] A transaction may constitute an applicable asset acquisition even though section 1031 (relating to like-kind exchanges) applies to a portion of the assets transferred.

[15] The provisions of section 1060 of the Code are not intended to preclude the Internal Revenue Service from applying the residual method in other situations, including situations not involving an applicable asset acquisition, pursuant to its authority under other provisions of the Code.

[16] No inference was intended as to the viability of the cost recovery method under prior law.

The Act also provides that, in the case of such contingent payments, the purchaser may not increase basis by any amount until the seller has included such amount in income.

Related parties include a person and all entities more than 50 percent owned, directly or indirectly, by that person. Related parties also generally include entities more than 50 percent owned, directly or indirectly, by the same persons.

Explanation of Provisions

The bill clarifies that the requirement that the purchaser may not increase basis by any amount until the seller has included such amount in income applies not only to contingent payments as to which the fair market value may not be reasonably ascertained but also to any other amount in an installment sale of depreciable property between related parties.

The bill also provides that related parties, for purposes of these installment sale provisions, include partnerships that are more than 50 percent owned, directly or indirectly, by the same persons.

H. Amortizable Bond Premium (sec. 106(j) of the bill, sec. 643 of the Reform Act, and sec. 171 of the Code)

Present Law

The deduction for amortizable bond premium is treated as interest, except as otherwise provided in regulations. Thus, for example, bond premium is treated as interest for purposes of applying the investment interest limitations.

The provision is effective for obligations acquired after October 22, 1986. For taxpayers who have elections in effect as of October 22, 1986, the statute provides that such elections will apply to obligations issued after that date only if the taxpayer so chooses (in such manner as may be prescribed by the Secretary).

Explanation of Provision

The bill provides that, for taxpayers who have elections in effect as of October 22, 1986, such elections will apply to obligations acquired after that date (rather than to obligations issued after that date) only if the taxpayer so chooses (in such manner as may be prescribed by the Secretary).

I. Certain Entity Not Taxed as a Corporation (sec. 646 of the Reform Act and sec. 106(k) of the bill)

Present Law

The Act provided that a certain trust (Great Northern Iron Ore Trust) is not taxed as a corporation if specified conditions are satisfied, including non-exercise of certain powers contained in its trust instrument.

Explanation of Provision

The bill makes certain clarifications and corrections regarding the conditions that must be satisfied in order that the trust not be taxed as a corporation.

J. Regulated Investment Companies (secs. 106(l)-106(o) of the bill, secs. 651-657 of the Reform Act, and secs. 851, 852 and 4982 of the Code)

Present Law

Under present law, in order to avoid paying an excise tax under section 4982, a regulated investment company ("RIC") is required to distribute during the calendar year specified percentages of its ordinary income and its capital gain net income for designated periods. The amount of capital gain net income for this purpose is not reduced by the amount of any net operating loss of the RIC.

A RIC is given sufficient earnings and profits under present law so that any distribution that otherwise is treated as dividend by the RIC may be treated as a dividend. No additional earnings and profits are created for redemption distributions that otherwise may qualify for a dividends paid deduction.

Under present law, a RIC must derive at least 90 percent of its income from certain specified sources including income that is derived with respect to its business of investing in stocks, securities or currencies (the "90 percent test"). In addition, a RIC must derive less than 30 percent of its gross income from the sale or other disposition of stock or securities held for less than 3 months (the "30 percent test").

Under present law, a corporation that is registered as a business development company under the Investment Company Act of 1940, is eligible to be a RIC.

Explanation of Provisions

Under the bill, for purposes of determining the amount that a RIC must distribute in order to avoid the excise tax under section 4982, a RIC may reduce (but not below its net capital gain) its capital gain net income (as computed for purposes of section 4981) by the amount of any "net ordinary loss" of the RIC. The net ordinary loss of the RIC is equal to the amount that would be the net operating loss of the RIC for the calendar year, with certain modifications. The net capital gain of the RIC for this purpose has the same meaning as under section 1221(11) determined by treating the one year period ending on October 31 of the calendar year (or such other one year period used by the RIC for purposes of section 4892) as the company's taxable year.

Under the bill, in the case of a RIC that does not have a taxable year ending on October 31, and has not made an election to use its own taxable year for purposes of computing the excise tax under section 4982, the earnings and profits of the RIC are determined without regard to any net capital loss attributable to transactions after October 31 of such year, but only to the extent that the amount distributed during the calendar year does not exceed the required distribution for such calendar year (as determined under section 4982).

The bill clarifies that income derived by the RIC from a partnership or trust is not income that is considered to be derived with respect to the RIC's business of investing in stocks, securities or currencies. In addition, the bill clarifies that the 30 percent test is applied with respect to sales or other dispositions of the stocks or securities (as defined for purposes of the 90 percent test); options, futures, or forward contracts; or, except as provided in regulations, foreign currencies.

The bill provides that a corporation that elects to be treated as a business development company under the Investment Company Act of 1940 is eligible to be a RIC.

K. Real Estate Investment Trusts (sec. 106(o)-106(s) of the bill, secs. 661-669 of the Reform Act, and secs. 856-857 and 4981 of the Code)

Present Law

Under present law, at least 75 percent of the gross income of a real estate investment trust (a "REIT") must be derived from certain specified sources including rents from real property and "qualified temporary investment income." Qualified temporary investment income is income attributable to stock or debt instruments that is attributable to the temporary investment of new capital (as defined in section 856(c)(6)(E)(ii)). In addition, present law provides that less than 30 percent of the gross income of a REIT must be derived from the sale or exchange of certain properties, including real property held for less than four years, with certain exceptions (the "30 percent test").

Under present law, a REIT generally may not treat amounts as rents from real property if the determination of such amounts depends in whole or in part on the income or profits of any person from such property. An exception is provided where a REIT receives or accrues amounts with respect to real or personal property from a tenant that derives substantially all of its income with respect to such property from the subleasing of substantially all of such property, and such tenant receives or accrues only amounts that would be treated as rents from real property if received by the REIT. A similar rule is provided for interest.

Under present law, in order to avoid paying an excise tax under section 4981, a REIT is required to distribute during a calendar year specified percentages of its ordinary income and its capital gain net income for the calendar year. The amount of capital gain net income for this purpose is not reduced by the amount of any net operating loss of the REIT.

Present law provides that income from a shared appreciation provision relating to a loan held by the REIT that is secured by a real property is treated as gain from the sale of the real property that secures the loan, effective for taxable years beginning after December 31, 1986.

Explanation of Provisions

The bill clarifies that for purposes of the definition of qualified temporary investment income, the term "debt instrument" has the same meaning as used for purposes of section 1275(a)(1). The bill provides that in the year in which a REIT is completely liquidated, for purposes of the 30 percent test, the REIT does not take into account any gain from the sale, exchange, or distribution of any property after the adoption of the plan of complete liquidation. The bill also provides that the provisions of the 1986 Act relating to the treatment of shared appreciation mortgages apply to taxable years beginning after December 31, 1986, but only with respect to obligations acquired after October 22, 1986.

The bill also clarifies that if a REIT receives or accrues amounts with respect to real or personal property from a tenant that derives substantially all of its income with respect to such property from the subleasing of substantially all of such property, and a portion of the amount that the tenant receives or accrues with respect to such property would be treated as rents from real property if received by the REIT, then the amounts received or accrued by the REIT from the tenant would not fail to be treated as rents from real property by reason of being based on the net income or profits of the tenant, to the extent that the amounts received or accrued by the REIT are attributable to amounts received by the tenant that would be treated as rents from real property if received by the REIT. A similar rule is provided for interest. In determining the portion of the rent (or interest) received from the tenant that may qualify as rent from real property (or interest) in these circumstances, allocation rules similar to those applicable under section 856(d)(4) (or section 856(f)(2)) are intended to apply.

Under the bill, for purposes of determining the amount that a REIT must distribute in order to avoid the excise tax under section 4981, a REIT may reduce its capital gain net income by the amount of any "net ordinary loss" of the REIT. The net ordinary loss of the REIT is an amount equal to the amount that would be the net operating loss of the REIT for the calendar year, with certain modifications.

L. Real Estate Mortgage Investment Conduits (secs. 106(t)-106(v) of the bill, secs. 671-675 of the Reform Act, and secs. 860A-860G and 856 of the Code)

Present Law

Under present law, if an entity ceases to be a real estate mortgage investment conduit ("REMIC") at any time during a taxable year, the entity may not be treated as a REMIC for such taxable year or any succeeding taxable year.

Under present law, a disposition of a qualified mortgage is treated as a prohibited transaction for a REMIC, with certain exceptions. No exception is provided for the repurchase of a defective mortgage in lieu of substitution. In addition, any disposition of a cash flow asset is treated as a prohibited transaction. Under present law, the treatment of contributions of property to the REMIC after the startup day is not certain.

Under present law, a qualified mortgage must be an obligation that is principally secured directly or indirectly by an interest in real property. It is unclear whether loans secured by stock in a cooperative housing corporation and debt instruments that are secured by other debt instruments, which other debt instruments are secured principally by interests in real property, may be treated as qualified mortgages. In general, a qualified mortgage must be transferred to a REMIC on or before the startup day, or purchased by the REMIC within three months of the startup day.

Under present law, the terms of a regular interest in a REMIC must be fixed on the startup day. Present law provides that a residual interest in a REMIC is any interest that is so designated and that is not a regular interest in a REMIC. Under present law, the startup day is any day selected by the REMIC that is on or before the first day on which regular interests in the REMIC are issued. Present law provides that a qualified reserve fund is any reasonably required reserve to provide for full payment of expenses of the REMIC or amounts due on regular interests in the event of defaults on qualified mortgages.

Under present law, property that would be foreclosure property for a real estate investment trust is a permitted investment for a REMIC for a one year period beginning with the time that the REMIC acquires such property. No tax is imposed on the REMIC with respect to income from foreclosure property.

Explanation of Provisions

Under the bill, if an entity ceases to be a REMIC during a taxable year by reason of a qualified liquidation, the entity may be treated as a REMIC for the taxable year in which the qualified liquidation occurs.

The bill provides that the repurchase of a defective mortgage in lieu of substitution is not treated as a prohibited transaction. The bill also provides that the sale of cash flow investments required to prevent defaults on a regular interest where the threatened defaults result from a default on one or more qualified mortgages is not treated as a prohibited transaction. In addition, if any property is contributed to the REMIC after the startup day, the bill imposes a tax on the REMIC for the taxable year in which the contribution is received equal to 100 percent of the amount (by value) of such contribution. Payments pursuant to a guarantee of qualified mortgages are not intended to be treated as a contribution for this purpose.

The bill clarifies the definition of a qualified mortgage by requiring that the qualified mortgage must be principally secured directly by an interest in real property. Thus, under the bill, debt instruments that are secured by other debt instruments, which other debt instruments are secured principally by interests in real property, may not be treated as qualified mortgages.[17] Nevertheless, the bill provides that loans secured principally by stock in a cooperative housing corporation may be treated as qualified mortgages.

---

[17] A regular interest in a REMIC, which is treated as a debt instrument for Federal income tax purposes, may be treated as a qualified mortgage, however.

The bill also provides that to be treated as a qualified mortgage, an obligation must be transferred to a REMIC on the startup day in exchange for regular or residual interests in the REMIC or purchased by the REMIC within three months of the startup day pursuant to a fixed price contract in effect on the startup day.[18]

The bill also provides that a regular interest in a REMIC must be issued on the startup day with fixed terms and must be designated as a regular interest. Under the bill, a residual interest also must be issued on the startup day. Under the bill, the startup day is any day in which the REMIC issues all of its regular and residual interests. In addition, to the extent provided in regulations, all interests issued and all transfers to the REMIC during any period (not exceeding 10 days) permitted in such regulations may be treated as occurring on the startup day.

Under the bill, a qualified reserve fund is any reasonably required reserve to provide for either full payment of expenses of the REMIC or amounts due on regular interests in the event of either defaults on qualified mortgages or lower than expected returns on cash flow investments.

Under the bill, a REMIC is subject to tax at the highest rate applicable to corporations on its "net income from foreclosure property." Net income from foreclosure property is the amount that would be the REMIC's net income from foreclosure property under section 857(b)(4)(B) if the REMIC were a real estate investment trust. Thus, if a REMIC acquires foreclosure property and receives amounts with respect to such property that would not be treated as certain types of qualifying income if received by a real estate investment trust (sec. 857(b)(4)(B)), then the REMIC would be subject to tax on such amounts. In addition, such property generally would be treated as foreclosure property for a period of two years, although this period may be shortened or extended under certain circumstances (sec. 856(e)). The amount of the REMIC's taxable income is reduced by any tax paid with respect to income from foreclosure property.

The bill also grants authority to the Treasury Department to provide appropriate rules for the treatment of transfers of qualified replacement mortgages to a REMIC where the transferor holds any interest in the REMIC. It is intended that these regulations may provide rules for determining the basis of mortgages transferred to or received from a REMIC as part of a replacement of qualified mortgages, and also may provide rules for determining or adjusting the basis of qualified mortgages held by the REMIC before or after the replacement. In addition, the bill grants authority to the Treasury Department to provide that a mortgage will be treated as a qualified replacement mortgage only if it is part of a bona fide replacement and is not part of a swap of mortgages.

The bill clarifies that certain provisions relating to REMICs are effective as of January 1, 1987. Thus, for example, interests in a REMIC are eligible to be treated as qualifying assets for a thrift institution, regardless of the institution's taxable year. In addition, the bill makes certain clerical and technical amendments to the statute.

---

[18] For this purpose, mortgages may be considered to be purchased pursuant to a fixed price contract despite the fact that the purchase price may be adjusted where the mortgages are not delivered by the seller on the startup day, provided that the adjustment is in the nature of damages for failure to deliver the mortgages rather than as a result of fluctuations in market price between the startup day and the date of delivery.

In general, the provisions of the bill are effective as of January 1, 1987. The provisions relating to the definition of the startup day, the definitions of regular and residual interests, the requirement that qualified mortgages be transferred to the REMIC in exchange for regular or residual interests on the startup day or purchased pursuant to a fixed price contract, and the 100-percent tax on contributions of property to REMICs after the startup day do not apply to any REMIC whose startup day (as defined under present law) is before July 1, 1987.

VII. Minimum Tax Provisions (Sec. 107 of the bill, sec. 501 of the Reform Act, and secs. 55-59 of the Code)

Present Law

Under present law, as amended by the Act, taxpayers are subject to an alternative minimum tax which is payable, in addition to all other tax liabilities, to the extent it exceeds the taxpayer's regular tax. The tax is imposed at a flat rate of 21 percent (20 percent in the case of a corporation) on alternative minimum taxable income in excess of an exemption amount. Alternative minimum taxable income generally is the taxpayer's taxable income, as increased or decreased by certain adjustments and preferences. The foreign tax credit and, to a limited extent in the case of corporations, the investment tax credit are allowed against the minimum tax.

Adjustments and preferences are provided for accelerated depreciation, mining exploration and development costs, certain long-term contracts, pollution control facilities, installment sales, circulation and research and experimental expenditures, individual itemized deductions, Merchant Marine Capital Construction Funds, special insurance deductions, percentage depletion, excess intangible drilling costs, incentive stock options, bad debt reserves, tax-exempt interest on certain bonds, appreciated property charitable deductions, farm losses, and passive losses. In addition, for 1987 through 1989, one-half of the excess of pre-tax book income of a corporation over other alternative minimum taxable income is a preference. For taxable years beginning after 1989, three-fourths of the excess of adjusted current earnings over other alternative minimum taxable income is a preference.

The provisions are effective for taxable years beginning after December 31, 1986.

Explanation of Provisions

Computation of tax.—The bill provides that a taxpayer's regular tax will be reduced by the possessions tax credit under section 27(b) since income eligible for the credit is not included in the minimum tax base. The bill also clarifies that where a corporation's tax base is measured by something other than taxable income, such as unrelated business taxable income, real estate investment trust taxable income, or life insurance company taxable income, alternative minimum taxable income is determined using that tax base.

Adjustments.—The bill clarifies that the percentage of contract completed used for purposes of determining the minimum tax adjustment for long-term contracts is the same percentage as used for regular tax purposes under section 460. The bill also clarifies that the deduction for regular tax purposes for personal exemptions is not allowed under the minimum tax, since a minimum tax exemption amount is provided. Further, the bill provides that only interest which is qualified residence interest for purposes of the regular tax may qualify as deductible housing interest for purposes of the minimum tax, and clarifies that minimum tax investment interest does not include minimum tax housing interest.

Book income.—The bill provides that an income statement that is filed with a Federal, state, or local government must be prepared for a substantial nontax purpose in order to be an applicable financial statement. Thus, an income tax return, franchise tax return or other similar return prepared for the purpose of determining any tax liability that is filed with Federal, State, or local authorities does not constitute an applicable financial statement. In addition, an income statement used by a government for statistical purposes only is not prepared for a substantial nontax purpose. The bill also provides that if a taxpayer has two or more financial statements with the same priority, the applicable financial statement shall be the one specified in regulations promulgated by the Secretary of the Treasury.

The gross amount of dividends (i.e. gross of any withholding taxes) received from a section 936 corporation, like dividends received from other nonconsolidated corporations, are included in the recipient's adjusted net book income. To the extent that the alternative minimum taxable income of the recipient is increased by reason of the inclusion of such dividends in adjusted net book income, the bill clarifies that a pro rata portion of withholding or income taxes is treated, for minimum tax purposes, as creditable foreign taxes paid by the recipient. The maximum amount of withholding or income taxes that may be treated as creditable foreign taxes is 50 percent of the taxes. However, this amount is reduced on a proportionate basis if a lesser amount of the dividends from the 936 corporation is taken into account in computing alternative minimum taxable income.

The bill also clarifies that if a taxpayer does not choose to take the benefit of section 901 with respect to income, war profits, or excess profits taxes imposed by a foreign country or possession of the United States, or is prohibited from taking the benefit of section 901 (i.e. taxes described in section 901(j)), adjusted net book income is reduced by only those taxes. That is, taxes which are not deductible for regular tax purposes (for example, withholding or income taxes imposed by a U.S. possession on dividends received from a section 936 corporation) are not deductible for this purpose. Similarly, the related income is to be reflected gross of any of these nondeductible taxes.

Adjusted current earnings.—The bill clarifies that the rule providing that income on an annuity contract is included in adjusted current earnings does not apply to a qualified annuity contract held under a plan described in section 403(a).

Preferences.—The bill clarifies that the preference for bond interest only applies to tax-exempt bonds and the exception for refunding bonds includes both current and advanced refundings. The bill also clarifies that the charitable contribution preference applies to trusts and estates as well as all other taxpayers. Finally, the bill provides that the incentive stock option preference applies notwithstanding that the stock is disposed of in a disqualifying disposition.

Investment tax credits.—The bill clarifies that the total amount of the general business credit allowable to a C corporation for a taxable year in which the regular tax exceeds the tentative minimum tax is determined as if any portion of the general business credit not attributable to the regular investment tax credit first offset the regular tax, and the regular investment credits (to the extent otherwise available) then reduced the net tax to 75 percent of the tentative minimum tax.

For example, assume a corporation had $100 million of regular tax, $80 million of tentative minimum tax, $30 million of regular investment tax credits (disregarding the cutback under section 49 for purposes of this example), and $20 million of other general business credits. $40 million of the general business credit would be allowed for the taxable year—$20 million by reason of the general rule of section 38(c)(1) allowing the general business credit to offset the excess of regular tax over tentative minimum tax and $20 million by reason of the special rule of section 38(c)(3) allowing unused regular investment credits to offset 25 percent of the tentative minimum tax. The above result would occur without regard to the taxable years in which the various credits arose.

The bill also clarifies that the regular investment tax credit cannot be used in a taxable year to the extent that it, in conjunction with the NOL deduction and the foreign tax credit, would reduce the amount of tax payable by the taxpayer to less than 10 percent of the tentative minimum tax (determined without regard to the NOL deduction and foreign tax credits).

Clerical amendments.— The bill makes numerous clerical amendments and corrects several cross references to these provisions.

Transitional provisions.—The bill provides that, for property that is depreciated under the new ACRS system during a taxable year of the taxpayer that begins before 1987, the new minimum tax depreciation (or pollution control facility amortization) rules apply to measure the preference, but the preference applies only to property to which the prior law rules of paragraphs (4) and (12) of section 57(a) applied. The bill also provides that in the case of a fiscal year trust or estate beginning in 1986 and ending in 1987, the prior law apportionment rules will apply notwithstanding that a beneficiary's taxable year begins in 1987. The bill also contains certain transition rules that were inadvertently amended or deleted in enrolling the Act.

VIII. Accounting Provisions (Sec. 108 of the Bill)

1. Limitation on the use of the cash method of accounting (sec. 108(a) of the bill, sec. 801 of the Reform Act, and secs. 448, 461, and 464 of the Code)

a. Definition of qualified personal service corporations

Present Law

Qualified personal service corporations are excepted from the general rule denying the use of the cash method of accounting to a C corporation or a partnership with a C corporation as a partner. A qualified personal service corporation is a corporation that meets both a function test and an ownership test. The function test is met if substantially all the activities of the corporation are the performance of services in the field or fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, and consulting.

The ownership test is met if substantially all (i.e., 95 percent) of the value of the outstanding stock in the corporation is owned, directly or indirectly, by employees performing services for the corporation in connection with the qualified services performed by the corporation, retired individuals who performed such services for the corporation or its predecessor(s), the estate of such an individual, or any other person who acquired stock by reason of the death of such an employee (for the two-year period beginning with the death of such employee).

A special rule is provided allowing the common parent of an affiliated group (within the meaning of section 1504(a)) to elect to treat all members of such affiliated group as one taxpayer for the purpose of determining if the ownership test is met, provided that substantially all of the activities of the members of such affiliated group involve the performance of services in the same field satisfying the function test.

Explanation of Provision

The bill provides that, for the purpose of determining if a corporation meets the ownership test, indirect ownership of stock is to be taken into account only where stock is owned indirectly through one or more partnerships, S corporations, or qualified personal service corporations. Thus, other forms of indirect stock ownership (e.g., as a result of attribution between family members or a holding company) are not considered in determining if the ownership test is satisfied. Stock that is owned by a partnership, S corporation, or qualified personal service corporation is considered to be owned by its owners in the same proportion as their ownership of the partnership, S corporation or qualified personal service corporation.

The bill also provides that a common parent of an affiliated group may elect to treat all members of such group as one taxpayer for the purpose of determining if the ownership test is met where substantially all of the activities of such affiliated group involve the performance of services in the same field satisfying the function test. Thus, if substantially all of the activities of the affiliated group, taken as a whole, are the performance of services in a field satisfying the function test, an election is available to apply the ownership test to the group as a whole. The function test, however, must still be applied to each separate corporation.

b. Requirement that tax shelters in oil and gas must pay cash before year end

Present Law

Under section 461(i), in the case of tax shelters, no deduction is allowed with respect to an item until there has been economic performance with respect to that item. Under a special rule applicable to tax shelters in oil and gas, economic performance with respect to drilling of an oil or gas well is deemed to occur at the time of spudding.

Explanation of Provision

When the special spudding rule for economic performance was adopted by Congress in the Defict Reduction Act of 1984, economic performance was deemed to occur at the time of spudding of an oil or gas well where the taxpayer had paid for the drilling costs prior to the close of the taxpayer's year. The Reform Act inadvertently removed the requirement that the taxpayer must have paid for the drilling costs by the close of the taxpayer's year in order for the special spudding rule to apply. The bill provides that tax shelters in oil and gas must have paid for the drilling activity before the end of its taxable year in order for spudding to be considered as economic performance.

c. Limitations on farming deductions

Present Law

Under Code section 464(a), farming syndicates are allowed a deduction for amounts paid for feed, seed, fertilizer, or other similar farm supplies no earlier than the taxable year in which such feed, seed, fertilizer, or other supplies actually are used or consumed.

Under Code section 464(b), farming syndicates are required to capitalize the cost of poultry purchased for use in a trade or business and to deduct such cost ratably over the lesser of 12 months or the useful life of such poultry in the trade or business. In addition, a farming syndicate may deduct only the cost of poultry purchased for sale in the taxable year in which the poultry is disposed of.

The Reform Act applies Code section 464(a) and 464(b) to certain persons prepaying 50 percent or more of certain farming expenses, with respect to the portion of such expenses exceeding 50 percent.

The Act denies the use of the cash method of accounting to any tax shelter. The definition of tax shelter for this purpose includes all farming syndicates.

Explanation of Provision

The bill provides that sections 464(a) and 464(b) shall not apply to farming syndicates in taxable years beginning after December 31, 1986, because these rules are duplicated by the rules of the Reform Act that require tax shelters to use an accrual method of accounting.

2. Capitalization rules for inventory, construction, and development costs (sec. 108(b) of the bill, sec. 803 of the Reform Act, and section 263A of the Code)

Present Law

In general, uniform cost capitalization rules apply to the manufacture or construction of all tangible property and to the purchasing and holding property for resale. Exceptions to these rules are provided for property produced by the taxpayer for personal use, research and experimental costs allowable as a deduction under section 174, certain development and other costs of oil and gas wells and mineral property deductible under section 263(c), 616(a), or 617(a), property produced pursuant to a long-term contract, and the production of timber and certain ornamental trees.

Interest costs are subject to special rules. Capitalization of interest is required only if the taxpayer is engaged in the manufacture or construction of property (i.e., resellers are exempt), and only if the property produced is real property or personal property that is long-lived or has an extended production period. Interest costs are allocable to the production or construction of property if they are directly attributable to production expenditures incurred in producing the property, or could have been avoided if the production expenditures had not been incurred. Interest incurred or continued in connection with property used to produce property is also subject to capitalization.

Special rules also apply to the production of farm products. In general, the uniform capitalization rules apply to such production only if the product has a preproductive period of more than two years. The special rule do not apply to taxpayers required to use an accrual method of accounting under section 447 or 448. Except for taxpayers using the annual accrual method of accounting, taxpayers required to use an accrual method of accounting must capitalize preproductive expenses.

Certain farmers otherwise required to capitalize preproductive period costs may elect to deduct them currently, provided the alternative cost recovery system is used on all farm assets and the expensed costs are recaptured upon disposition of the product. The election is not available to taxpayers required to use the accrual method of accounting or engaged in the production of pistachios. In addition, costs incurred in replanting edible crops following loss or damage due to freezing temperatures, disease, drought, pests, or casualty may be deducted currently. This exception may apply to costs incurred by persons other than the taxpayer who incurred the loss or damage, provided (1) the taxpayer who incurred the loss or damage retains an equity interest of more than 50 percent in the property on which the loss or damage occurred and (2) the person claiming the deduction materially participates in the planting or maintenance of the property during the four-taxable year period beginning with the year of the loss or damage.

Explanation of Provision

The bill adds to the list of costs specifically exempted from the uniform capitalization rules (1) costs incurred in connection with oil and gas wells or mineral property that are subject to amortization over sixty months pursuant to section 291(b)(2), and (2) costs (other than circulation expenditures) subject to ten-year amortization under section 59(e). The bill also clarifies that, in determining the amount of interest that must be capitalized in connection with an asset used to produce property, the methods applied under the general interest allocation rules are applied to the full cost of the asset.[1] Accordingly, any interest specifically traceable to such an asset must first be allocated to the produced property; interest on other debt of the taxpayer is then allocated to the extent required under the avoided cost method.[2]

Finally, the bill clarifies that a cost is subject to capitalization under this provision only to the extent it is otherwise taken into account in computing taxable income for any taxable year. Thus, for example, the portion of a taxpayer's interest expense that is allocable to personal loans, and hence is disallowed under section 163(h), may not be included in a capital or inventory account and recovered through depreciation or amortization deductions, as a cost of sales, or in any other manner.

The special rule for costs incurred by persons other than the taxpayer in connection with replanting a crop of the taxpayer following loss or damage due to freezing temperatures, etc., is modified. Under the bill, such costs may be deducted without regard to whether they were incurred (or the persons' material participation occurs) within the four-taxable year period following the loss or damage.

Many taxpayers using the annual accrual method of accounting, other than taxpayer's engaged in the trade or business of growing sugar cane, were required under section 278 of prior law to capitalize preproductive expenses (e.g., citrus growers). The Reform Bill repealed section 278. The bill restricts the taxpayers that use the annual accrual method of accounting that may expense preproductive expenses to taxpayers engaged in the trade or business of farming sugar cane.

---

[1] If an asset is not used exclusively in the production of a single property, the total interest cost associated with the asset is allocated among the various properties produced.

[2] To avoid double counting, any interest allocated to property under this rule is not again allocated to the property under the general interest allocation rule. For example, interest allocated under the general rule to depreciation on an asset used to produce property, which would be a production expenditure that would "attract" interest under the avoided cost method, might otherwise duplicate interest allocated under this special rule for production-related assets.

3. Long-term contracts (sec. 108(c) of the bill, sec. 804 of the Reform Act, and sec. 460 of the Code)

Present Law

Taxpayers engaged in the production of property under a long-term contract must compute income from the contract under either the percentage of completion method or the percentage of completion-capitalized cost method. Under the percentage of completion method, the taxpayer must include in gross income for the taxable year an amount equal to the product of (1) the gross contract price and (2) the percentage of the contract completed during the taxable year. The percentage of a contract completed during the taxable year is determined by comparing costs incurred with respect to the contract during the year with the estimated total contract costs.

In the taxable year in which a contract reported under the percentage of completion method is completed, a determination is made whether the taxes paid with respect to the contract in each year of the contract were more or less than the amount that would have been paid if gross income had been computed by using the actual gross contract price and the actual total contract costs, rather than the anticipated contract price and costs. Interest must be paid by the taxpayer if, applying this "lookback" method, there is an underpayment by the taxpayer with respect to a taxable year. Similarly, interest must be paid to the taxpayer by the Internal Revenue Service if there is an overpayment.

Under the percentage of completion-capitalized cost method, the taxpayer must take into account 40 percent of the items with respect to the contract under the percentage of completion method. The remaining 60 percent of the items under the contract must be taken into account under the taxpayer's normal method of accounting (e.g., completed contract method, accrual shipment method).

Costs that directly benefit, or are incurred by reason of, a taxpayer's long-term contract activities must be allocated to its long-term contracts in the manner provided in the Treasury regulations under section 451 for extended period long-term contracts. This method of allocation is required irrespective of whether the contract is reported under the percentage of completion-capitalized cost method or the percentage of completion method. While costs may be deducted in the year incurred if they relate to a contract (or portion of a contract) reported under the percentage of completion method, whether costs are allocable to such a contract is nonetheless relevant because it affects the determination of the percentage of the contract completed during the year.

Explanation of Provision

The bill authorizes the Secretary of the Treasury to prescribe a simplified procedure for the allocation of costs to a contract for purposes of applying the percentage of completion method. Thus, for example, the Secretary may permit the determination of the percentage of a contract completed during the taxable year to be based on fewer costs than are taken into account for purposes of applying the completed contract method or other long-term contract method of accounting. This simplified method may not be used by taxpayers using the percentage of completion-capitalized method for accounting for long-term contracts.

4. Taxable years of certain entities (sec. 108(e) of the bill, sec. 806 of the Reform Act, and secs. 706, 1378, 441, and 267 of the Code)

a. Majority interest taxable years

Present Law

A partnership may not have a taxable year other than the taxable year of the partners owning a majority interest in partnership profits and capital. If partners owning a majority of partnership profits and capital do not have the same taxable year, the partnership must adopt the same taxable year as its principal partners. If the principal partners of the partnership do not have the same taxable year and no majority of its partners have the same taxable year, the partnership must adopt the calendar year or such other period as the Secretary of the Treasury may prescribe by regulations.

The majority interest rule does not apply unless the period that constitutes the taxable year of partners owning a majority interest in partnership profits and capital has been the same for the three-taxable-year period of such partners ending on or before the beginning of such taxable year of the partnership. If the partnership has not been in existence for all of such three-taxable-year period, the period that constitutes the taxable year of the partners owning a majority interest in profits and capital must have been the same for the taxable years of such partners ending with or within the period of the partnership's existence.

Explanation of Provision

The bill provides that a partnership may not have a taxable year other than its majority interest taxable year. If the partnership does not have a majority interest taxable year, it may not have a taxable year other than the taxable year of all of its principal partners. If the partnership does not have a majority interest taxable year and all of its principal partners do not have the same taxable year (or the partnership has no principal partners), the partnership may not have a taxable year other than the calendar year, unless the Secretary of the Treasury, by regulations, prescribes another period.

The majority interest taxable year is the taxable year (if any) that, on the testing day, constituted the taxable year of one or more partners having (on the testing day) an aggregate interest in partnership profits and capital of more than 50 percent. Generally, the testing day is the first day of the partnership taxable year. The Secretary of the Treasury may provide that an alternate, representative period be used as the testing day, rather than the first day of the taxable year, if such period is more representative of the ownership of the partnership. A partnership that is required to change its taxable year to its majority interest taxable year is not required to change to another taxable year for either of the two taxable years following the year of change.

b. Sequence of required changes in taxable years

Present Law

The requirement of the Reform Act that partnerships conform their taxable years to the taxable years of their owners does not take into consideration changes in taxable years of such owners that also may be required by the Act. Thus, such partnerships may be required to change their taxable years several times as the taxable years of their owners change.

Explanation of Provision

The bill provides that, except as otherwise provided in the regulations issued by the Treasury Regulations, the changes in taxable years of other persons required to change taxable years are to be taken into account in determining the required taxable year of a partnership.

c. Personal service corporations

Present Law

A personal service corporation is required by the Reform Act to adopt a calendar year, unless it establishes to the satisfaction of the Secretary of the Treasury a business purpose for a different taxable year. A personal service corporation is a corporation the principal activity of which is the performance of personal services if services are substantially performed by employee-owners.

Explanation of Provision

The bill provides that a corporation is not considered to be a personal service corporation for this purpose unless more than 10 percent of the stock (by value) in such corporation is held by employee-owners.

The bill further provides that, if a corporation is a member of an affiliated group filing a consolidated return, all members of such group shall be taken into account in determining whether such corporation is a personal service corporation.

d. Common trust funds

Present Law

The Reform Act did not address the taxable year to be used by a common trust fund taxed under section 584.

Explanation of Provision

Consistent with the rules requiring use of a calendar year for other pass-through entities (e.g., partnerships, S corporations, trusts), the bill requires the taxable year of a common trust fund be the calendar year. If a common trust fund is required to change taxable years as a result of this provision, and as a result of such change a participant in such common trust fund is required to include items from more than one taxable year of the common trust fund in any of the participant's taxable years, the items from the short taxable year of the common trust fund may be included in income by the participant ratably over a four-taxable-year period, unless the participant elects to include all such income currently.

e. Effective date

Present Law

The Reform Act provided that, if any partner or shareholder of an S corporation is required to include the items from more than one taxable year of the partnership or S corporation in any one taxable year, income in excess of expenses for the short taxable year of the partnership or S corporation is to be taken into account ratably in each of the first four taxable years (including such short taxable year) beginning after December 31, 1986, unless the partner or shareholder of the S corporation elects to include all such income in the short taxable year.

The Internal Revenue Service has issued a revenue procedure which sets forth rules under which the Service will permit electing S corporations to adopt taxable years other than a calendar year. Rev. Proc. 83-25, 1983-1 C.B. 689. Under the so-called "25-percent test" of that revenue procedure, an electing S corporation generally may adopt, retain, or change to a taxable year if, among other tests, 25 percent or more of the gross income of the taxpayer is realized in the last two months of that year.

Explanation of Provision

The bill clarifies that the four year spread provided by the Reform Act for partners and shareholders in S corporations is only applicable to changes in taxable years that are required by the Reform Act for the first taxable year beginning after December 31, 1986. In addition, the bill clarifies that the four year spread is made at that partner or shareholder level, rather than at the level of the partnership or S corporation.

The bill provides that the Internal Revenue Service is not required to permit taxpayers to have an automatic change of a taxable year. Thus, taxpayers meeting the "25-percent test" of Rev. Proc. 83-25 are not automatically permitted to adopt or change to a year allowed under that revenue procedure.

5. Treatment of installment obligations (sec. 108(f) of the bill, sec. 812 of the Reform Act, and secs. 453 and 453C of the Code)

Present Law

In applying the proportionate disallowance rule under present law, the installment percentage of a taxpayer's average quarterly indebtedness generally is treated as a payment on the taxpayer's applicable installment obligations. The taxpayer's year-end indebtedness may be used instead of average quarterly indebtedness if the taxpayer has no applicable installment obligations arising from dealer sales outstanding at any time during the taxable year. In addition, in applying the proportionate disallowance rule, all assets and indebtedness of certain related taxpayers are aggregated.

Under present law, applicable installment obligations include installment obligations arising from certain specified types of sales, which installment obligations are held by the seller or a member of the same affiliated group (within the meaning of section 1504(a) without regard to section 1504(b)) as the seller. Obligations arising from sales of personal property pursuant to a revolving credit plan or obligations arising from the sale of publicly traded property may be treated as applicable installment obligations. Under present law, personal use property and indebtedness secured primarily by such property are not taken into account for purposes of applying the proportionate disallowance rule of section 453C to applicable installment obligations arising from dealer sales.

Under present law, taxpayers who are required to change their method of accounting for sales pursuant to a revolving credit plan because of section 812 of the Reform Act must take into income any adjustment arising under section 481 over a period of four years, with specified percentages for each of the four years.

Explanation of Provisions

The bill provides that taxpayers who have no applicable installment obligations outstanding at year-end other than applicable installment obligations arising from non-dealer sales, must use their year-end indebtedness, rather than their average quarterly indebtedness for purposes of applying the proportionate disallowance rule. The bill provides that personal use property and indebtedness secured primarily by such property are not taken into account for purposes of applying the proportionate disallowance rule of section 453C to applicable installment obligations arising from non-dealer sales. The bill also grants authority to the Treasury Department to issue regulations modifying the rules requiring aggregation of the assets and indebtedness of certain related taxpayers.

The bill clarifies that the term "applicable installment obligation" includes installment obligations arising from certain specified types of sales, which installment obligations are held by the seller or any person if the basis of such obligation in the hands of such person is determined (in whole or in part) by reference to the basis of such obligation in the hands of another person and such obligation was an applicable installment obligation in the hands of such other person. Thus, for example, if an applicable installment obligation is transferred to a partnership or a trust in a nonrecognition transaction and the partnership or trust has a carryover basis in the installment obligation, then the obligation is treated as an applicable installment obligation in the hands of the partnership or trust.

The bill also clarifies that installment obligations arising from the sale of personal property pursuant to a revolving credit plan or from the sale of publicly traded property are not treated as applicable installment obligations. Thus, such installment obligations are not subject to the proportionate disallowance rule. In addition, the bill clarifies that the provision denying the use of the installment method for sales of publicly traded property applies with respect to sales of such property after December 31, 1986.

In addition, the bill clarifies how the proportionate disallowance rule is applied with respect to applicable installment obligations arising after February 28, 1986, but in a taxable year prior to the first taxable year ending after December 31, 1986. The bill specifies that any such applicable installment obligations are treated as arising on the first day of the first taxable year of the taxpayer ending after December 31, 1986.

The bill provides that if a taxpayer's last taxable year beginning before January 1, 1987, was the taxpayer's first taxable year in which sales were made under a revolving credit plan, then all adjustments under section 481 are taken into account in the taxpayer's first taxable year beginning after December 31, 1986. The bill also provides that if a taxpayer sells any receivables that arose pursuant to a revolving credit plan and that were taken into account in computing the adjustment under section 481 relating to the change from the installment method to the accrual method, then the taxpayer may not recognize any loss on the sale of such receivables. If a loss is realized on any such sale, however, then the taxpayer may reduce the aggregate amount of the adjustment under section 481 for the fourth taxable year beginning after December 31, 1986, by the amount of such loss; to the extent that the loss exceeds the aggregate adjustment for such fourth taxable year, then the adjustment for the third taxable year is reduced, and so on.

Further, the bill corrects certain clerical and technical errors.

6. Income attributable to utility services (sec. 108(i) of the bill, sec. 821 of the Reform Act, and sec. 451 of the Code)

Present Law

Accrual basis taxpayers are required to recognize income attributable to the furnishing or sale of utility services to customers not later than the taxable year in which such services are provided to the customer. For taxable years beginning after December 31, 1986, the year in which utility services are provided may not be determined by reference to the time the customer's meter is read or to the time that the customer is billed (or may be billed) for such services.

For any taxable year beginning before August 16, 1986, a method of accounting that took into account income from the furnishing or sale of utility services on the basis of the period in which the customer's meters were read is deemed to be proper for Federal income tax purposes.

Explanation of Provision

The bill provides that, for taxable years beginning on or after August 16, 1986, and before January 1, 1987, a method of accounting that took into account income from the furnishing or sale of utility services on the basis of the period in which the customer's meters were read is deemed to be proper for Federal income tax purposes, provided such income was treated in the same manner for the preceding taxable year.

IX. Financial Institutions (Sec. 109 of the Bill)

1. Limitations on bad debt reserves (sec. 109(a) of the bill, sec. 901 of the Reform Act, and sec. 46(c)(4) of the Code)

Present Law

Section 901 of the Act reduced the portion of taxable income that thrift institutions (mutual savings banks, domestic building and loan associations, and cooperative banks) may deduct as an addition to reserves for bad debts from a maximum of 40 percent to eight percent. In addition, an institution otherwise meeting the definition of a thrift institution was required to hold at least 60 percent of its assets in qualifying assets in order to meet the definition of a thrift institution.

Prior and present law limits the amount of investment eligible for the investment tax credit in the case of a thrift institution to 50 percent of the amount otherwise allowable. Where a thrift institution is the lessee of property that is eligible for the investment tax credit, the lessor is treated as a thrift institution with respect to such property, unless the thrift institution has elected to compute its deduction for bad debts using the experience method. Such an election is binding on the thrift institution for all subsequent years.

Explanation of Provision

The bill provides that an election by a lessee thrift institution to use the experience method of computing its deduction for bad debts shall terminate effective with respect to the first taxable year of the electing organization beginning after 1986 and during which such organization (or any successor organization) was not the lessee under any lease of regular investment tax credit property. Regular investment tax credit property is any section 38 property if the regular percentage applied to such property and the amount of qualified investment with respect to such property would have been reduced but for the election by the organization.

The effect of the provision is to allow a thrift institution that had committed to the use of the experience method of accounting for bad debts in order to avoid certain reductions in investment tax credit to use the percentage of income method in taxable years beginning after 1986, provided the thrift institution is not a lessee of property that was eligible for investment tax credit without reduction as a result of the prior election.

2. Interest on debt used to purchase or carry tax-exempt obligations (sec. 109 of the bill, sec. 902 of the Act, and secs. 265 and 291 of the Code)

Present Law

The Act denies banks, thrift institutions, and other financial institutions a deduction for that portion of the taxpayer's otherwise allowable interest expense that is allocable to tax-exempt obligations acquired by the taxpayer after August 7, 1986 (sec. 265(b)).[1] The portion of interest disallowed is equivalent to the ratio of (1) the average adjusted basis during the taxable year of tax-exempt obligations held by the financial institution and acquired after August 7, 1986, to (2) the average adjusted basis of all assets held by the financial institution. A 20-percent disallowance continues to apply (as under pre-1986 law) with respect to tax-exempt obligations acquired between January 1, 1983, and August 7, 1986.

An exception to the proportional disallowance rule is provided for qualified tax-exempt obligations acquired by a financial institution. Qualified tax-exempt obligations include any tax-exempt obligation which (1) is not a private activity bond, as defined under Title XIII of the Act,[2] and (2) is issued by an issuer which reasonably anticipates to issue not more than $10 million of tax-exempt obligations (other than private activity bonds, as defined above) during the calendar year. Qualified tax-exempt obligations must be designated as such by the issuer; not more than $10 million of obligations may be so designated for any calendar year.

For purposes of applying the limitations with respect to qualified tax-exempt obligations, an issuer and all subordinate entities are treated as one issuer.

Qualified tax-exempt obligations are treated as if acquired by the financial institution on August 7, 1986. Interest allocable to such obligations thus remains subject to the 20 percent disallowance rule contained in pre-1986 law.

Explanation of Provisions

The bill makes several amendments to the exception for qualified tax-exempt obligations, as follows:

Application of $10 million limit

The bill clarifies that, in applying the $10 million limitation with respect to qualified tax-exempt obligations, all tax-exempt obligations (other than private activity bonds, as defined above) which the issuer reasonably anticipates to issue during the calendar year are taken into account. Thus, only an issuer that reasonably anticipates to issue $10 million or less of such obligations during the calendar year (including designated and undesignated issues) may designate any of these obligations for purposes of the exception.

---

[1] This rule is applied after the general disallowance rule applicable to all taxpayers (sec. 265(a)(2)).

[2] For purposes of this exception only, qualified 501(c)(3) bonds (as defined in Title XIII of the Act) are not treated as private activity bonds. Additionally, certain bonds receiving transitional exceptions under Title XIII of the Reform Act, and which would not have been industrial development bonds (IDBs) or private loan bonds under prior law, are not treated as private activity bonds.

Treatment of composite issues

The bill specifies the treatment of composite issues (i.e., combined issues of bonds for different entities) for purposes of the exception. Under the bill, composite issues qualify for the exception only if the requirements of the exception are met (1) with respect to the composite issue as a whole (determined by treating the composite issue as a single issue), and, additionally, (2) with respect to each separate lot of obligations which is a part of the issue (determined by treating each separate lot of obligations as a separate issue). Thus, a composite issue may qualify for the exception only if the composite issue itself does not exceed $10 million, and if, additionally, each issuer benefiting from the composite issue reasonably anticipates to issue not more than $10 million of tax-exempt obligations (other than private activity bonds, as described above) during the calendar year, including bonds issued through the composite arrangement. *See also*, the conditions under which bonds of different issuers are aggregated for purposes of the $10 million limit, described below.

Aggregation of issuers

The bill clarifies the operation of the provision under which an issuer and all subordinate entities are aggregated for purposes of the $10 million limitation. The following rules are provided:

(1) An issuer and all entities which issue bonds "on behalf of" [3] that issuer are to be treated as one issuer.

(2) If an issuer is subordinate to another entity but does not issue bonds on behalf of another entity, bonds issued by the subordinate entity are taken into account in applying the $10 million limitation to the entity to which it is subordinate.

(3) If an entity is formed or (to the extent provided in Treasury regulations) availed of for purposes of avoiding the $10 million limitation, such entity and any other entity (or entities) purporting to benefit from this device are treated as one issuer.

Treatment of refunding bonds

Under the bill, the treatment of refunding bonds is also clarified. Specifically, any bond used to refund (other than in an advance refunding) a previously issued bond is not to be taken into account, for purposes of applying the $10 million limitation to other, nonrefunding bonds. Refunding bonds themselves may qualify for designation under the exception for qualified tax-exempt obligations only if (1) the refunded bond was designated, qualified for, and was taken into account under, the $10 million limitation when issued, (2) the aggregate face amount of the issue of which the refunding bond is a part does not exceed $10 million, (3) except in the case of refundings of bonds having a weighted average maturity of 3 years or less, the weighted average maturity of the refunding issue does not exceed the weighted average maturity of the refunded bonds, and (4) no bond which is part of the refunding issue has a maturity in excess of 30 years (measured from the date of issuance of the refunded bonds).

---

[3] *See, e.g.*, Rev. Rul. 63-20, 1963-1 C.B. 24.

Designation of certain bonds issued in reliance on House bill

The bill specifies that only obligations issued after August 7, 1986, may be designated for purposes of the exception. For obligations issued after August 7, 1986, and before January 1, 1987, the period for making a designation is not to expire before January 1, 1988.

A special rule is provided for certain obligations issued before August 8, 1986, in reliance on a similar exception contained in the House version of the 1986 Act.[4] Under this rule, if (1) an obligation was issued after December 31, 1985, and before August 8, 1986, (2) when the obligation was issued, the issuer designated that it intended the obligation to qualify under section 802(e)(3) of the House bill, and (3) the issuer reaffirms its election under the 1986 Act, then the obligation is treated as issued on August 8, 1986.

Effective dates

The provisions regarding aggregation of entities, refundings, and composite issues are effective for obligations issued after June 30, 1987. (At the election of the issuer, these provisions are effective as if included in the 1986 Act). Other provisions are effective as if included in the 1986 Reform Act.

---

[4] H.R. 3838 (99th Congress), as passed by the House of Representatives on December 17, 1985.

X. Insurance Provisions (Secs. 110 and 118(g) and (i) of the Bill)

1. Treatment of certain market discount bonds (sec. 110(a) of the bill and sec. 1011(d) of the Reform Act)

Present Law

The Reform Act repealed the prior-law 28 percent alternative tax rate for corporate long-term capital gains, for years for which the new corporate tax rates are fully effective (i.e., taxable years beginning on or after July 1, 1987). Thus, corporate net capital gain for such years is taxed at regular corporate rates (i.e., generally a maximum 34 percent rate under the Reform Act). For taxable years that include periods prior to the time the new rates are fully effective, the alternative tax rate under the Reform Act on gain properly taken into account under the taxpayer's method of accounting after December 31, 1986, is 34 percent. These rules apply to all items of long term capital gain, including gain attributable to market discount on bonds issued before July 19, 1984, which was treated as long-term capital gain under the transition rules of the Deficit Reduction Act of 1984.

The Deficit Reduction Act of 1984 generally required income attributable to market discount to be treated as ordinary income rather than capital gain on disposition of a bond (Code sec. 1276). However, the 1984 Reform Act grandfathered market discount gain on bonds issued before July 19, 1984.

Under the Reform Act, a special rule is provided for gain with respect to certain bonds of certain specified life insurance companies. Pursuant to this rule, gain representing market discount recognized by such companies on the redemption at maturity of any bond which was issued before July 19, 1984, and acquired by the company on or before September 25, 1985, is subject to tax at the rate of 28 percent.

Explanation of Provision

The bill extends the special rule under the Reform Act to all life insurance companies with a modification of the tax rate. Under the bill, the tax rate on gain subject to the special rule is 31.6 percent, rather than 28 percent.

2. Status of certain organizations providing commercial-type insurance (sec. 110(b) of the bill and sec. 1012 of the Reform Act)

Present Law

Under present law, an organization described in sections 501(c)(3) or (4) of the Code is exempt from tax only if no substantial part of its activities consists of providing commercial-type insurance. In the case of such a tax-exempt organization, the activity of providing commercial-type insurance is treated as an unrelated trade or business but, in lieu of the usual tax on unrelated trade or business taxable income, the unrelated trade or business activity is taxed under the rules relating to insurance companies (subchapter L of the Code).

Commercial-type insurance does not include insurance provided at substantially below cost to a class of charitable recipients. Commercial-type insurance also does not include health insurance provided by a health maintenance organization (i.e., any health maintenance organization, tax-exempt under prior law, which is substantially the same as a Federally chartered health maintenance organization), if such health insurance is of a kind customarily provided by such organizations and is incidental to the organization's principal activity of providing health care. Commercial-type insurance also does not include property and casualty insurance provided by certain church organizations or conventions or associations of churches, if certain requirements are met.

The provision does not apply to certain organizations, including Delta Dental Plans Association and the Missouri Hospital Association.

Explanation of Provision

The exceptions from the provision for Delta Dental Plans Association and for the Missouri Hospital Association are restated to apply to Delta Dental Plans Association organizations and to the Missouri Hospital Plan, respectively.

The bill also provides Treasury regulatory authority to prescribe rules providing proper adjustments in the case of organizations that have a fiscal taxable year and that become subject to tax by reason of the provision, where the organization has a short taxable year that begins during 1987 by reason of rules requiring property and casualty insurance companies generally to have a calendar taxable year.

3. Inclusion in income of 20 percent of unearned premium reserve (sec. 110(c) of the bill, sec. 1021 of the Reform Act, and sec. 832(b)(7) of the Code)

Present Law

Present law, as amended by the Reform Act, provides that a property and casualty insurance company generally is required to reduce its deduction for increases in unearned premiums by 20 percent. In addition, such companies are required to include in income 20 percent of the unearned premium reserve outstanding at the end of the most recent taxable year beginning before January 1, 1987, ratably over the 6 taxable years following such year.

The provision requiring ratable inclusion of the pre-1987 unearned premium reserve applies to a company without regard to whether the company had computed its taxable income by taking into account additions to an unearned premium reserve. Thus, the ratable inclusion rule applies, under the Reform Act, to organizations that were exempt from Federal income tax prior to 1987 and to small companies that were taxed solely on investment income.

The Reform Act did not provide special rules for reciprocal insurers.

Explanation of Provision

Treatment of certain formerly exempt companies.—The bill provides that if, at all times prior to its 1987 taxable year, a company was exempt from tax under section 501(a) by virtue of being described in a paragraph of section 501(c), or was a small company subject to tax only on investment income, then the ratable inclusion rule does not apply. This clarification reflects the intent that no inclusion of prior reserve amounts is appropriate if the company received no tax benefit from the reserve amounts due to its former fully or partially tax-exempt status.

Phase-in treatment.—The bill also adjusts the period over which inclusion of 20 percent of the outstanding balance of the unearned premium reserve is required in the case of a company that (1) is exempt from tax under section 501(a) by virtue of being described in any paragraph of section 501(c), or is subject to tax only on investment income for its first taxable year beginning after 1986; and (2) was subject to tax as a property and casualty insurance company in a year beginning before 1987. Such companies generally computed taxable income taking into account a reserve for the gross amount of unearned premiums. In such a case, the 20 percent ratable inclusion rule applies for the 6-year period that begins with the first taxable year after 1986 in which the company is subject to tax under section 831(a).

Treatment of reciprocal insurers.—The bill provides that, in the case of an interinsurer or reciprocal underwriter (within the meaning of sec. 835) that is required under applicable State law to report on its annual statement reserves on unearned premiums net of premium acquisition expenses, the amount of the unearned premiums is to be treated as including an amount equal to such expenses for purposes of the decrease in the deduction for unearned premiums. Otherwise, such taxpayers would be subject to ratable inclusion of a portion of the unearned premium reserve that did not give rise to mismatching of income and deductions under prior law, which the ratable inclusion rule was intended to address.

4. Treatment of certain dividends and tax-exempt interest (sec. 110(d) of the bill, sec. 1022 of the Reform Act, and sec. 832(b)(5) of the Code)

Present Law

Present law, as amended by the Reform Act, provides that the deduction of a property and casualty company for losses incurred is reduced by 15 percent of (1) the property and casualty insurance company's tax-exempt interest and (2) the deductible portion of dividends received (with special rules for dividends from affiliates). For purposes of this proration provision, tax-exempt interest includes interest income excludable under section 103 (or deductible under sec. 832(c)(7)), the portion of interest income excludable under section 133, and other similar items. If the amount of this reduction exceeds the amount otherwise deductible as losses incurred, the excess is includible in income.

Explanation of Provision

The bill clarifies the treatment of dividends received for purposes of applying the proration provision in the case of a property and casualty insurance company that files a consolidated return. Under the bill, the determination with respect to any dividend paid by a member to another member of the affiliated group filing the consolidated return is made as if the group were not filing a consolidated return.

The bill also clarifies that the deductible portion of any dividends received from a subsidiary, including those received directly or indirectly from a lower tier subsidiary, are subject to the proration rules in the hands of the property and casualty insurance affiliate. These provisions conform to the application of the proration rules generally to all property and casualty insurance companies.

5. Loss reserves (sec. 110(e) of the bill, sec. 1023 of the Reform Act, and sec. 846 of the Code)

Present Law

The Reform Act provides for the discounting of the deduction for additions to loss reserves of property and casualty insurance companies to take account partially of the time value of money. The discounting of such deductions is applicable to loss reserves of property and casualty companies, and to loss reserves of life insurance companies that are not required to be discounted under life insurance reserve rules. Special rules are provided in the case of certain accident and health, international, and reinsurance lines of business. The discounting of loss reserves is effective for taxable years beginning after 1986, with a fresh start provision with respect to undiscounted loss reserves applicable to the last taxable year beginning before 1987.

Explanation of Provisions

The bill clarifies that, with respect to the special rule for discounting unpaid loss reserves in certain accident and health lines of business (other than unpaid losses relating to disability income), it is assumed that unpaid losses are paid in the middle of the year following the accident year. This assumption is intended to conform to the general assumption for loss reserve discounting purposes that losses are paid in the middle of the year.

The bill provides that the Secretary may prescribe regulations to determine appropriate adjustments in the application of the unpaid loss discounting provisions, in the case of a taxpayer having a taxable year other than the calendar year. Although most property and casualty companies have a calendar taxable year, some companies filing a consolidated return with noninsurance companies will have a fiscal taxable year. The Reform Act did not provide special rules that are used in applying the discounting rules to such fiscal year taxpayers.

The regulations also should provide appropriate adjustments in the application of the discounting provisions in cases where the Reform Act resulted in a required change in a company's period of accounting (e.g., where the Reform Act results in the application for the first time of sec. 843, which generally requires property and casualty insurance companies to utilize a calendar taxable year).

The bill also clarifies the application of the fresh start provision in the case of an insurance company that (1) is exempt from tax under section 501(a) by virtue of being described in any paragraph of section 501(c) or, under section 831(b), is taxed only on investment income, in a year beginning after 1986, and (2) later becomes subject to tax under section 831(a) as a regular property and casualty insurance company. The rules relating to the fresh start under the discounting provisions are to be applied by treating the last taxable year before the year in which such a company becomes subject to tax under sec. 831(a) as the company's last taxable year beginning before 1987.

6. Election to be taxed only on investment income (sec. 110(f) of the bill, sec. 1024 of the Reform Act, and sec. 831(b) of the Code)

Present Law

The Reform Act provided that mutual and stock property and casualty insurance companies with net written premiums or direct written premiums (whichever is greater) in excess of $350,000, but less than $1,200,000, may elect to be taxed only on taxable investment income.

Explanation of Provisions

The bill clarifies that the election to be taxed only on investment income, once made and so long as the requirements for the election are met, may be revoked only with the consent of the Secretary. This clarification reflects Congress' intent that the election not be used as a means of eliminating tax liability (e.g., by making the election only for years when the taxpayer does not have net operating losses), but rather as a simplification for small companies.

7. Treatment of Physicians' and Surgeons' Mutual Protection Associations (sec. 110(g) of the bill and sec. 1031 of the Reform Act)

Present Law

Under the Reform Act, initial contributions to a pooled malpractice insurance association are currently deductible to the extent they do not exceed the cost of a commercial insurance premium for annual coverage and are included in the association's income. Refunds of such contributions are deductible to the fund only to the extent included in the income of the recipient. The Reform Act provision applies to associations operating under State law prior to January 1, 1984.

Explanation of Provision

The bill clarifies that initial contributions to a pooled malpractice insurance association under the provision include otherwise qualifying contributions whether paid all in one year or in up to six annual installments, provided, of course, that the total amount of the contribution does not exceed the cost of a commercial insurance premium for annual coverage. Members of the association are intended to include provisional members (i.e., those association members who have paid one or more, but not all, of the annual installments of their initial contribution).

8. Special rule for mutual life insurance company (sec. 110(h) of the bill and sec. 217(i) of the Deficit Reduction Act of 1984)

Present Law

The Deficit Reduction Act of 1984 provided that a mutual life insurance company may elect to treat all individual noncancellable (or guaranteed renewable) accident and health contracts as through they were cancellable for purposes of determining under section 816 whether or not it is subject to tax as a life insurance company or a property and casualty insurance company. Stock life insurance subsidiaries of electing mutual companies are treated as though they were mutual life insurance companies.

Explanation of Provision

The bill provides that, for purposes of determining the amount of the small life insurance company deduction of a controlled group including an electing mutual company, the taxable income of the electing company is taken into account in applying the phaseout of the small life insurance company deduction, for taxable years beginning after 1986 and before 1992. The bill further provides that the decrease in the amount of Federal revenue by reason of this provision shall not exceed $300,000 per taxable year.

9. Annuity diversification requirements (sec. 110(i) of the bill, sec. 1821(m) of the Reform Act, and sec. 817(h) of the Code)

Present Law

Present law provides that certain variable contracts that are based on a segregated asset account generally are not treated as annuity contracts if the investments made by such account are not (as provided in Treasury regulations) adequately diversified. No special rule is provided for immediate annuities. Treasury regulations were published September 12, 1986, setting forth requirements for adequate diversification of certain variable contracts, including immediate annuities.

Explanation of Provision

The bill provides additional time to comply with the annuity diversification requirement, in the case of variable contracts that are immediate annuities (as defined in sec. 72(u)(4)) that were issued by September 12, 1986, and that do not (as of that date) meet the diversification requirements set forth in the September 12, 1986, regulations because the investments made by the segregated asset accounts under the contracts were invested in Government-guaranteed investments (FDIC- or FSLIC-guaranteed deposits). In such cases, the diversification requirement with respect to Government securities (including Government-guaranteed investments) is waived until December 31, 1988, but applies in full on and after January 1, 1989.

10. Treatment of alternative minimum tax with respect to shareholders surplus account (sec. 110(j) of the bill and sec. 815(c) of the Code)

Present Law

Present law provides that, in the case of a stock life insurance company having an existing policyholder surplus account, a shareholders surplus account must be continued in order to maintain a record for tax purposes of amounts eligible for distribution before a distribution is made from the policyholders surplus account (and, generally, treated as taxable to the distributing company). In general, the excess of the following amounts over the taxes paid for the year are added to the shareholders surplus account: (1) life insurance company taxable income (but not below zero); (2) the small life insurance company deduction; (3) the dividends received deduction allowed; and (4) excluded tax-exempt interest.

Explanation of Provision

The bill provides that, under regulations, in determining additions to the shareholders surplus account, proper adjustments are to be made for any year in which alternative minimum tax is imposed under section 55 of the Code and for all subsequent years. The provision was intended to take account, in calculating the amount in the shareholders surplus account, of net tax liability of the company, and thus should take into account minimum tax and the minimum tax credit.

11. Treatment of certain items as not interest for source rules (sec. 110(k) of the bill, sec. 1215 of the Reform Act, and sec. 818(f) of the Code)

Present Law

The Reform Act's legislative history indicates that deductions of life insurance companies that are described in Code section 807(c)(1), (2), (3), and (6) should not be treated as interest expenses, under the source rules, for allocation purposes (new Code sec. 864(e), added by section 1215 of the Reform Act). This language could lead to the inference that deductions described in section 807(c)(4) and (5) are interest expenses for allocation purposes.

Explanation of Provision

The bill clarifies that deductions of life insurance companies that are described in Code section 807(c) (which includes paragraphs (1) through (6)) are not to be treated as interest expenses for allocation purposes under new Code section 864(e), added by section 1215 of the Reform Act.

12. Technical corrections to the Deficit Reduction Act of 1984 (secs. 118(g) and (i) of the bill, secs. 1821 and 1825(a)(4) of the Reform Act, and secs. 812(e) and 7702 of the Code)

Present Law

Determination of policyholders' share of gross investment income.—Present law provides that the policyholders' share of tax-exempt interest reduces a life insurance company's deduction for certain reserves. For purposes of determining the policyholders' share, sec. 812(e) provides that gross investment income excludes any dividend received by the life insurance company that is a 100-percent dividend. Whether a dividend is a 100-percent dividend is determined by reference to the definition in sec. 805(a)(4)(C), not including dividends described in sec. 805(a)(4)(D). The Reform Act modified the provisions of secs. 805(c)(4)(C) and (D).

Certain policies to cover burial or funeral expenses.—Present law, as amended by the Reform Act, provides that future increases in death benefits may be taken into account in determining whether the definition of a life insurance contract is satisfied with respect to certain policies to cover payment of burial expenses or in connection with prearranged funeral expenses. Such contracts can qualify as life insurance contracts, provided that certain requirements (relating to limitations on increases in the death benefit) are satisfied. The Reform Act provided no specific effective date for the provision.

Explanation of Provisions

Determination of policyholders' share of gross investment income.—The bill clarifies that the prior-law definition of 100-percent dividends continues to apply for purposes of determining gross investment income within the meaning of section 812. Thus, the provision is intended to retain the definition as under prior law.

Certain policies to cover burial or funeral expenses.—The bill provides that the rule that future increase in death benefits may be taken into account under the definition of a life insurance contract, with respect to certain policies to cover payment of burial expenses or in connection with prearranged funeral expenses, is effective for contracts entered into on or after October 22, 1986. Congress intended that the provision be prospectively effective.

XI. Pensions and Deferred Compensation; Employee Benefits; ESOPs (Secs. 111, 111A, 111B, and 118(q) of the Bill)

A. Limitations on Treatment of Tax-Favored Savings

1. Individual retirement arrangements (IRAs) (sec. 111(a) and (b) of the bill, secs. 1101 and 1102 of the Reform Act, and secs. 219, 408, 4973, and 6693 of the Code)

a. IRA deduction limit

Present Law

Under present law (sec. 219), a taxpayer is permitted to make deductible IRA contributions up to the lesser of $2,000 or 100 percent of compensation (earned income in the case of a self-employed individual) if:

(1) in the case of a taxpayer who is not married or is married but files a separate return, the taxpayer either (a) has adjusted gross income (AGI) that does not exceed the applicable dollar amount or (b) is not an active participant in an employer-maintained retirement plan for any part of the plan year ending with or within the taxable year; or

(2) in the case of married taxpayers filing a joint return, either (a) the couple has AGI that does not exceed the applicable dollar amount or (b) neither spouse is an active participant in an employer-maintained retirement plan for any part of the plan year ending with or within the taxable year.

The applicable dollar amount is (1) $25,000, in the case of an unmarried individual, (2) $40,000, in the case of a married couple filing a joint return, and (3) $0, in the case of a married taxpayer filing separately. The otherwise applicable IRA dollar limit (i.e., $2,000) is reduced by an amount that bears the same ratio to such dollar limit as the taxpayer's AGI in excess of the applicable dollar amount (or, in the case of a married couple filing a joint return, the couple's AGI in excess of the applicable dollar amount) bears to $10,000.

Explanation of Provision

Present law creates an unintended incentive for married couples to file separate returns. If one spouse is an active participant and the other spouse is not, the couple can increase their IRA deduction limit under certain circumstances by filing separate returns.

In order to eliminate this incentive for a married couple living together, the bill provides that, for purposes of determining whether an IRA contribution is deductible for a taxable year, if the couple lives together at any time during the year, the active participant status of both spouses is taken into account for purposes of calculating the IRA deduction limit. If the spouses file separate returns, the applicable dollar amount is $0 and only the AGI of the spouse making the IRA contribution is taken into account.

Also under the bill, a taxpayer is not considered married for a year if the taxpayer and the taxpayer's spouse (1) did not live together at any time during the taxable year, and (2) did not file a joint return for the taxable year. A taxpayer meeting these requirements for a taxable year is treated as an unmarried individual for the taxable year. Accordingly, for purposes of determining the taxpayer's deduction limit, only the taxpayer's AGI and status as an active participant is taken into account, and the applicable dollar amount is $25,000.

b. Nondeductible IRA contributions

Present Law

Under present law, an individual is permitted to make designated nondeductible IRA contributions to the extent that deductible contributions are not allowed due to the AGI phaseout for active participants. In addition, a taxpayer may elect to treat otherwise deductible IRA contributions as nondeductible.

An individual who makes a designated nondeductible contribution to an IRA for a taxable year or who receives a distribution from an IRA during a taxable year is required to provide such information as the Secretary may prescribe on the individual's tax return for the taxable year and, to the extent required by the Secretary, for succeeding taxable years (or on such other form as the Secretary may prescribe). The information that may be required includes, but is not limited to, (1) the amount of designated nondeductible contributions for the taxable year, (2) the amount of distributions from individual retirement plans for the taxable year, (3) the aggregate amount of designated nondeductible contributions for all preceding taxable years which have not previously been withdrawn, and (4) the aggregate balance of all IRAs of the individual as of the close of the calendar year with or within which the taxable year ends. An individual who overstates the amount of designated nondeductible contributions for a year is subject to a penalty of $100 for each overstatement unless it is shown that the overstatement is due to reasonable cause.

Explanation of Provision

Under present law, there is no separate penalty with respect to an individual who fails to file the form prescribed by the Secretary with respect to nondeductible IRA contributions. Accordingly, under the bill, a taxpayer who fails to file the form required by the Secretary is subject to a penalty of $50 for each such failure unless the taxpayer shows that the failure is due to reasonable cause.

In order to take into account taxpayers with fiscal year taxable years, the bill provides that the information that the Secretary may require to be included on the form or return includes the aggregate balance of all IRAs of the individual as of the close of the calendar year in which the taxable year begins (rather than the calendar year with or within which the taxable year ends).

c. IRA withdrawals

Present Law

Present law provides that amounts withdrawn from an IRA during a taxable year are includible in income for the taxable year under rules similar to the rules applicable to qualified plans under section 72. Under special rules applicable to IRAs for purposes of section 72, (1) all IRAs of an individual (including rollover IRAs and simplified employee pensions (SEPs), but excluding deductible qualified voluntary employee contributions) are treated as 1 contract, (2) all distributions that are made during a taxable year are treated as 1 distribution, (3) the value of the contract (calculated after adding back distributions that are made during the year), income on the contract, and investment in the contract are computed as of the close of the calendar year with or within which the taxable year ends, and (4) the aggregate amount of withdrawals excludable from income for all taxable years shall not exceed the taxpayer's investment in the contract for all taxable years.

Explanation of Provision

Under the bill, for purposes of applying the special IRA rules of section 72, the value of the contract (calculated after adding back distributions that are made during the year), income on the contract, and investment in the contract are computed as of the close of the calendar year in which the taxable year begins (rather than the calendar year with or within which the taxable year ends). The provision is intended to facilitate computations with respect to taxpayers with fiscal year taxable years.

d. Excess contributions

Present Law

Distribution prior to due date of return

Under present law (sec. 408(d)(4)), the normal rules for the taxation of distributions (sec. 72) do not apply to a distribution of contributions to an IRA (and, consequently, the contributions are not taxed upon distribution) if (1) the contributions exceed the amount allowable as a deduction under section 219, (2) the distribution is received on or before the due date (including extensions) for the individual's return for the taxable year, (3) no deduction is allowed under section 219 with respect to the excess contributions, and (4) the distribution is accompanied by the amount of net income attributable to the excess contributions. The net income on the contributions is deemed to have been earned and receivable in the taxable year in which the excess contributions were made.

Distribution after due date of return

If the total contributions made to all IRAs for a year (excluding rollover IRAs) does not exceed $2,250, then, under present law, the normal rules for the taxation of distributions (sec. 72) do not apply to a distribution of contributions in excess of the amount allowable as a deduction under section 219 if the excess contributions are distributed after the due date (including extensions) for filing the individual's tax return for the year the contributions were made (sec. 408(d)(5)). For purposes of this rule, the amount allowable as a deduction under section 219 (after application of section 408(o)(2)(B)(ii)) is increased by the nondeductible limit under section 408(o)(2)(B).

Excise tax

Present law provides a 6-percent nondeductible excise tax on contributions to an IRA in excess of the amount allowable as a deduction under section 219 for a taxable year, if the excess contributions are not timely distributed (sec. 4973(b)). For purposes of this rule, the amount allowable as a deduction under section 219 (after application of section 408(o)(2)(B)(ii)) is increased by the nondeductible limit under section 408(o)(2)(B).

Explanation of Provision

Distribution prior to due date of return

The bill amends the rules relating to distributions of excess contributions to take into account the fact that nondeductible contributions may be made to an IRA. The bill permits any IRA contributions to be distributed without income or excise tax consequences prior to the due date (including extensions) for filing the individual's income tax return for the year the contributions are made. Thus, under the bill, the normal rules for the taxation of IRA distributions do not apply to a distribution of any contributions to an IRA if (1) the distribution is received on or before the due date (including extensions) for the individual's return for the taxable year for which the contributions were made, (2) no deduction is allowed under section 219 with respect to the contributions, and (3) the distribution is accompanied by the amount of net income attributable to the contributions. As under present law, net income on the contributions are deemed to have been earned and receivable in the taxable year in which the contributions were made.

Distribution after due date of return

The bill clarifies the intent that certain IRA contributions not in excess of $2,250 may be withdrawn by providing that, for purposes of the rule relating to return of excess contributions after the due date of the individual's return for the year for which the contributions were made, the amount allowable as a deduction under section 219 is computed without regard to the AGI phaseout for active participants (sec. 219(g)).

Excise tax

The bill provides that, for purposes of the excise tax on excess contributions to an IRA, the amount allowable as a deduction under section 219 is computed without regard to the AGI phaseout for active participants (sec. 219(g)).

2. Qualified cash or deferred arrangements (sec. 111(c) and (l) of the bill, secs. 1105 and 1116 of the Reform Act, and secs. 401(k), 402, and 4979 of the Code)

a. Limit on elective deferrals

Present Law

In general

Present law provides that the maximum amount that an employee can elect to defer for any taxable year under all cash or deferred arrangements in which the employee participates is limited to $7,000. This $7,000 limit is adjusted for inflation at the same time and in the same manner as the indexing of the dollar limit on benefits under section 415(d). The $7,000 limit applies to the employee's taxable year, regardless of the employer's taxable year or the plan year applicable to the cash or deferred arrangement. The $7,000 limit is coordinated with other plans to which elective deferrals are made.

To ease the administrative burden on employees, employers, and the IRS, the elective deferral arrangements maintained by any single employer may preclude an employee from making elective deferrals under such arrangements for a taxable year in excess of $7,000.

Treatment of excess deferrals

If, for any taxable year, the total amount of elective deferrals contributed on behalf of an employee to all qualified cash or deferred arrangements and other plans subject to the limit in which the employee participates exceeds $7,000, then the amounts in excess of $7,000 (the excess deferrals) are included in the employee's gross income for the taxable year to which the deferral relates. In addition, with respect to any excess deferrals, by March 1 after the close of the employee's taxable year, the employee may allocate the excess deferrals among the qualified cash or deferred arrangements and other plans subject to the limit in which the employee participates and notify the administrator of each plan of the portion of the excess deferrals allocated to that plan. Not later than April 15 after the close of the employee's taxable year, each plan may (but is not required to) distribute to the employee the amount of the excess deferrals (plus income attributable to the excess deferrals) allocated to the plan.

The distribution may be made without regard to the terms of the plan until the close of the first plan year for which an amendment is required (Act sec. 1140) and notwithstanding any other provision of law. In addition, the Secretary is to prescribe a model plan amendment which permits the distribution of excess deferrals. Distribution pursuant to such amendment is to be treated as in accordance with the plan.

Income on excess deferrals distributed by the applicable April 15 date is treated as earned and received in the taxable year to which the excess deferral relates. Excess deferrals (and earnings thereon) distributed by the applicable April 15 date are not subject to the additional income tax on early withdrawals (sec. 72(t)). Deferrals are not subject to the 10-percent excise tax on nondeductible contributions (sec. 4972) merely because they are excess deferrals.

Reporting requirements

Under the Act, the employer is required to report to an employee and to the IRS the amount of elective deferrals made by the employee and the amount of compensation deferred under section 457 (sec. 6051(a)).

Explanation of Provision

In general

The bill provides that income on excess deferrals is includible in gross income in the year distributed, rather than in the year of the deferral. To prevent individuals from electing to make excess deferrals in order to defer current taxation of income, the bill requires, as a condition of qualification, that a plan that has a cash or deferred arrangement is required to provide that elective deferrals under the arrangement and under all other plans, contracts, or arrangements of the employer maintaining the plan for a calendar year may not exceed the limitation on elective deferrals in effect for taxable years beginning in such calendar year. A similar restriction is required to be included in a simplified employee pension (SEP) (sec. 408(k)), tax-sheltered annuity contract (sec. 403(b)), or section 501(c)(18) plan that permits elective deferrals. The provision is generally effective with respect to plan years beginning after December 31, 1987. A delayed effective date applies with respect to employees who participate in a plan maintained pursuant to a collective bargaining agreement if the employees are covered by the bargaining agreement.

Treatment of excess deferrals

Under the bill, income on excess deferrals distributed before the applicable April 15 date, including income earned during and after the year to which the deferral relates, is includible in income in the year distributed, rather than in the year to which the deferral relates. The bill clarifies that any distribution of less than the entire amount of excess deferrals plus income attributable to such deferrals is treated as a pro rata distribution of excess deferrals and income.

The bill clarifies that excess deferrals (and income on such deferrals) distributed by the applicable April 15 are not subject to the 15-percent tax on excess distributions (sec. 4980A).

Reporting requirements

The Act did not contain an effective date for the reporting requirement relating to elective deferrals. The reporting requirement was intended to be effective at the same time the Act's limit on elective deferrals was effective. Accordingly, the bill provides that the requirement is effective with respect to calendar years beginning after December 31, 1986.

b. Nondiscrimination requirements

Present Law

Under present law, a special nondiscrimination test applies to limit the elective deferrals that may be made by highly compensated employees. The limit depends (in part) on the level of elective deferrals by nonhighly compensated employees. A cash or deferred arrangement under which only highly compensated employees participate or are eligible to participate does not satisfy the special nondiscrimination test. For purposes of applying the special nondiscrimination test, under rules prescribed by the Secretary, employer matching contributions that are nonforfeitable and that satisfy certain withdrawal restrictions may be taken into account.

If the special nondiscrimination rules are not satisfied for any year, present law provides that the qualified cash or deferred arrangement will not be disqualified if the excess contributions (plus income allocable to the excess contributions) are distributed before the close of the following plan year. In addition, instead of receiving an actual distribution of excess contributions, an employee may elect to have the excess contributions treated as an amount distributed to the employee and then recontributed by the employee to the plan on an after-tax basis. Such recharacterization is not permitted in the absence of regulations. A plan may provide that an employee is required to make such a recharacterization election as a condition of plan participation.

Distribution of excess contributions may be made notwithstanding any provision of the plan until the first plan year for which plan amendments are required (Act sec. 1140) and notwithstanding any other provision of law. In addition, the Secretary is to prescribe a model plan amendment that permits the distribution of excess deferrals. Distribution pursuant to such amendment is to be treated as a distribution made in accordance with the plan. The amount distributed is not subject to the 10-percent additional income tax on early withdrawals (sec. 72(t)). Contributions are not subject to the 10-percent excise tax on nondeductible contributions (sec. 4972) merely because they are excess contributions.

Prior to the Deficit Reduction Act of 1984 (DEFRA), proposed Treasury regulations permitted a cash or deferred arrangement that failed the special nondiscrimination test to be qualified if the arrangement satisfied the general nondiscrimination rules (sec. 401(a)(4)). DEFRA provided that a cash or deferred arrangement is not qualified unless it satisfies the special nondiscrimination test (with an exception provided in DEFRA sec. 527(c)(1)(B)). Although the Act modified the nondiscrimination requirements, it did not change the rule enacted in DEFRA section 527(c)(1)(B).

For a discussion of the excise tax on excess contributions and excess aggregate contributions (sec. 4979), see below.

Explanation of Provision

The bill clarifies that, for purposes of the special nondiscrimination test, the elective deferrals of eligible highly compensated employees, rather than all highly compensated employees are taken into account. Under prior law, highly compensated employees were defined by reference to eligible employees. However, the new uniform definition of highly compensated employees does not refer to eligible employees and, therefore, the clarification is necessary to obtain a result consistent with prior law.

The bill provides that, for purposes of determining whether matching contributions may be used to satisfy the special nondiscrimination test for elective deferrals, a matching contribution is not treated as forfeitable merely because the matching contribution is forfeited because the contribution to which it relates is an excess deferral (sec. 402(g)(2)(A)), an excess contribution (sec. 401(k)(8)(B)), or an excess aggregate contribution (sec. 401(m)(6)(B)). The bill clarifies that excess contributions distributed (or treated as distributed) by the end of the plan year following the year the excess contributions arose are not subject to the excise tax on excess distributions (sec. 4980A).

c. Withdrawal restrictions

Present Law

Under present law, withdrawals generally are not permitted under a qualified cash or deferred arrangement prior to death, disability, separation from service, or (except in the case of a pre-ERISA money purchase pension plan or a rural electric cooperative plan) the attainment of age 59-1/2. However, a qualified cash or deferred arrangement (other than a pre-ERISA money purchase pension plan or a rural electric cooperative plan) may permit hardship withdrawals up to the amount of the employee's elective deferrals (but not income on the elective deferrals).

In addition, under the Act, distributions may be made from a qualified cash or deferred arrangement upon (1) termination of the plan without the establishment of a successor plan, (2) the date of sale by a corporation of substantially all of the assets used by the corporation in a trade or business if the employee continues employment with the corporation acquiring the assets, or (3) the date of the sale by a corporation of the corporation's interest in a subsidiary if the employee continues employment with the subsidiary. The Statement of Managers for the Act provided that a distribution upon any of these 3 events is permitted only if the distribution constitutes a total distribution of the employee's balance to the credit in the cash or deferred arrangement.

Explanation of Provision

As originally enacted, the exception to the withdrawal restrictions for certain sales of assets or subsidiaries is unduly restrictive, as it does not encompass other transactions that have the effect of sales of assets or subsidiaries. The bill expands the exception to include dispositions of assets or subsidiaries other than sales and clarifies that the exception only applies if the transferor corporation continues to maintain the plan after the disposition. Thus, the bill provides that distributions can be made from a qualified cash or deferred arrangement on the (1) disposition by a corporation of substantially all of the assets (within the meaning of sec. 409(d)(2)) used by such corporation if the employee continues employment with the transferor corporation and the transferor corporation continues to maintain the plan, or (2) disposition by a corporation of the corporation's interest in a subsidiary (within the meaning of sec. 409(d)(3)) if the employee continues employment with the subsidiary and the transferor corporation continues to maintain the plan.

The bill incorporates statutorily the requirement that a distribution must be a total distribution in order for the exception for dispositions of assets or subsidiaries or termination of a plan to apply. Under the bill, a distribution upon any of these 3 events is permitted only if the distribution is a "lump sum distribution". For this purpose, "lump sum distribution" means a lump-sum distribution under the income averaging rules (sec. 402(e)(4)), but without regard to (1) the required events (such as attainment of age 59-1/2) for eligibility for income averaging, (2) the election requirement, and (3) the minimum period of plan participation requirement. Thus, for this purpose, a distribution can constitute a lump sum distribution even though, for example, the employee receives the distribution prior to age 59-1/2, has already elected lump sum treatment for a prior distribution, or has not been a participant in the plan for at least 5 years.

d. Other restrictions

Present Law

Under the Act, a cash or deferred arrangement is not qualified if any employer contributions or benefits (other than matching contributions) are conditioned (either directly or indirectly) upon an employee's elective deferrals. The Statement of Managers provides that this prohibition is not limited to employer-provided benefits.

The Act prohibits tax-exempt organizations and State and local governments (or a political subdivision of a State or local government) from establishing qualified cash or deferred arrangements. The restriction does not apply to a rural electric cooperative plan.

In addition, the prohibition does not apply to plans adopted before (1) May 6, 1986, in the case of an arrangement maintained by a State or local government (or political subdivision of a State or local government), or (2) July 2, 1986, in the case of an arrangement maintained by a tax-exempt organization. The grandfather treatment is limited to the employers who adopted the plan before the dates specified above. However, the grandfather treatment is not limited to employees (or classes of employees) covered by the plan as of the date the grandfather treatment is provided. Similarly, plans that are grandfathered may be amended in the future. Most such plans will, of course, have to be amended to take into account the new requirements relating to qualified cash or deferred arrangements. Other plan amendments may also be made. For example, a grandfathered plan may be amended in the future to provide for employer matching contributions, to modify the level of employer matching contributions, or to provide that the qualified cash or deferred arrangement is part of a cafeteria plan.

Explanation of Provision

The bill reconciles the statutory provision and the intent of Congress articulated in the Statement of Managers by providing that the prohibition on conditioning benefits on elective deferrals is not limited to employer-provided benefits. Thus, for example, a plan may not provide that voluntary after-tax employee contributions may not be made until an employee makes a specified amount of elective deferrals under a qualified cash or deferred arrangement.

The bill modifies the grandfather rule applicable to section 401(k) plans maintained by governmental employers. Under the bill, the prohibition on section 401(k) plans does not apply to (1) an employer that is a State or local government (or political subdivision of a State or local government) if the employer adopted a section 401(k) plan before May 6, 1986, and (2) an employer that is a tax-exempt governmental unit other than a governmental unit described in (1) (e.g., the Tennessee Valley Authority), if the employer adopted a section 401(k) plan before July 2, 1986. Because the grandfather rule in the bill applies to the employer and not merely the plan, an employer that satisfies the conditions of the grandfather may adopt a new section 401(k) plan.

Because the identity of the employer is more likely to change in the case of tax-exempt employers that are not governmental entities (such as through a merger of unrelated tax-exempt organizations), the bill limits this expansion of the grandfather rule to tax-exempt governmental units.

3. Nondiscrimination requirements for employer matching contributions and employee contributions (sec. 111(m) of the bill, sec. 1117 of the Reform Act, and secs. 401(m) and 4979 of the Code)

a. Special nondiscrimination test

Present Law

In general

Under present law, a special nondiscrimination test is applied to employer matching contributions and employee contributions, including employee contributions under a qualified cost-of-living arrangement (sec. 415(k)). This special nondiscrimination test is similar to the special nondiscrimination test applicable to qualified cash or deferred arrangements.

The term "employer matching contributions" means any employer contribution made to the plan on behalf of an employee on account of an employee contribution or an elective deferral under a qualified cash or deferred arrangement. Forfeitures under a plan that are reallocated to participants' accounts on the basis of employee contributions or elective deferrals are, of course, also treated as matching contributions.

Required aggregation

If 2 or more plans of an employer to which matching contributions, employee contributions, or elective deferrals are made are treated as a single plan for purposes of the coverage requirements for qualified plans (sec. 410(b)), then the plans are treated as a single plan for purposes of the special nondiscrimination test. In addition, if a highly compensated employee participates in 2 or more plans of an employer to which matching contributions, employee contributions, or elective deferrals are made, then all such contributions are aggregated for purposes of the special nondiscrimination test.

Explanation of Provision

In general

Under the bill, the special nondiscrimination test applicable to matching contributions and employee contributions only applies to contributions to defined contribution plans within the meaning of sec. 414(k). Also under the bill, the definition of "matching contributions" includes any contribution to a defined contribution plan made on account of an employee contribution or an elective deferral under a qualified cash or deferred arrangement, whether such contributions are made to the same plan or a different plan. Contributions to a defined benefit pension plan may be employee contributions or matching contributions to the extent treated as contributions to a defined contribution plan (sec. 414(k)). The bill also clarifies, in accordance with the Statement of Managers, that contributions to a tax-sheltered annuity which are made on account of an employee contribution or elective deferral are employer matching contributions.

Under the bill, employer matching contributions that are treated as elective deferrals for purposes of the special nondiscrimination test applicable to cash or deferred arrangements are not subject to the special test applicable to matching contributions and employee contributions.

Required aggregation

The bill modifies the requirement with respect to aggregation of plans in which a highly compensated employee participates. Under the bill, if a highly compensated employee participates in 2 or more plans of an employer to which contributions subject to the special nondiscrimination test (sec. 401(m)) are made, then all such contributions are aggregated for purposes of the test. For example, assume an employer maintains a plan with a cash or deferred arrangement under which matching contributions are made, and a thrift plan providing for after-tax employee contributions and matching contributions. Highly compensated employees participate in both plans. Under the bill, matching contributions that are not treated as elective deferrals in applying the special section 401(k) nondiscrimination test and after-tax contributions under the plans are aggregated for purposes of the special nondiscrimination test. The elective deferrals, however, are not required to be aggregated with the matching contributions and employee contributions.

b. Treatment of excess aggregate contributions

Present Law

If the special nondiscrimination test is not satisfied for any year, the plan will not be disqualified if the excess aggregate contributions (plus income allocable to such contributions) are distributed before the close of the following plan year. Distribution of excess aggregate contributions by such date may be made notwithstanding any other provision of law, and the amount distributed is not subject to the additional income tax on early withdrawals (sec. 72(t)). Contributions are not subject to the 10-percent tax on nondeductible contributions (sec. 4972) merely because they are excess aggregate contributions.

An excise tax is imposed on the employer with respect to excess contributions and excess aggregate contributions (sec. 4979). The tax is equal to 10 percent of the excess contributions and excess aggregate contributions (but not earnings on those contributions) under the plan for the plan year ending in the taxable year.

However, the tax does not apply to any excess contributions or excess aggregate contributions that, together with income allocable to such contributions, are distributed (or, if nonvested, forfeited) no later than 2-1/2 months after the close of the plan year in which the contributions arose.

Excess contributions (plus income), excess matching contributions (plus income), excess elective deferrals (plus income), excess qualified nonelective contributions (plus income), and income on excess employee contributions distributed within the applicable 2-1/2 month period are to be treated as received and earned by the employee in the employee's taxable year to which such contributions relate. Excess matching contributions are deemed to relate to the same taxable year to which the employee's mandatory contribution relates, i.e., mandatory contributions that are elective deferrals relate to the taxable year in which the employee would have received (but for the deferral election) the deferral as cash, and mandatory contributions that are employee contributions relate to the taxable year of contribution. For purposes of this rule, the first contributions (of the type distributed) for a plan year are deemed to be excess contributions or excess aggregate contributions.

Explanation of Provision

The bill provides that excess aggregate contributions for a plan year that are distributed before the end of the following plan year are not subject to the 15-percent excise tax on excess distributions (sec. 4980A).

In addition, to be consistent with the rules applicable to excess deferrals and excess contributions, the bill provides that such distributions may be made without regard to the terms of the plan until the close of the first plan year for which an amendment is required (Act sec. 1140). The bill similarly provides that the Secretary is to prescribe a model amendment that allows a plan to distribute excess aggregate contributions and that a plan distribution in accordance with such amendment is to be treated as in accordance with the terms of the plan. It is understood that the Secretary has already prescribed model amendments under the Act; accordingly, it is not intended that the Secretary be required to prescribe a new amendment regarding excess aggregate contributions.

The Act provides that excess contributions and excess aggregate contributions that are distributed within 2-1/2 months after the end of the plan year are treated as received and earned by the recipient in the taxable year to which the contribution relates in order to prevent deferral of income. Such deferral is not of major concern, however, where the amount involved is not significant. Accordingly, the Act provides an exception to the general rule. Under this exception, if the total distributions of excess contributions and excess aggregate contributions under a plan for a plan year with respect to an individual are less than $100, then the distributions are treated as earned and received by the individual in the taxable year in which the distributions were made.

4. Unfunded deferred compensation arrangements of State and local governments and tax-exempt employers (sec. 111(e) of the bill, sec. 1107 of the Reform Act, and sec. 457 of the Code)

a. Application to tax-exempt employers; distribution requirements

Present Law

The Act applies the limitations and restrictions applicable to eligible and ineligible unfunded deferred compensation plans of State and local governments (sec. 457) to unfunded deferred compensation plans maintained by nongovernmental tax-exempt organizations.

Under the Act, distributions cannot be made available to participants or beneficiaries under a section 457 plan before the participant is separated from service with the employer or is faced with an unforeseeable emergency. In addition, distributions under a section 457 plan are required to comply with the provisions of section 401(a)(9). Under section 401(a)(9) as amended by the Act, distributions must begin no later than the April 1 of the calendar year following the calendar year the participant attains age 70½, regardless of whether the participant is still employed. Thus, section 401(a)(9) may require that distribution is to begin before the time that distributions are permitted under section 457.

Explanation of Provision

The bill reconciles the rules under section 457 and section 401(a)(9) relating to the time that distributions are to be made. With respect to the rule prohibiting distributions prior to separation from service or the occurrence of an unforeseen emergency, the bill provides an exception for distributions in or after the year in which the employee attains age 70½. Thus, under the bill, amounts may not be available under a section 457 plan earlier than (1) the calendar year in which the participant attains age 70½, (2) when the participant separates from service, or (3) when the participant is faced with an unforeseeable emergency.

b. Amount of deferrals

Present Law

Under present law, an unfunded deferred compensation plan is not an eligible plan if it permits deferred compensation in excess of the limits contained in section 457. The limit on deferred compensation under a section 457 plan is coordinated with contributions to a tax-sheltered annuity (sec. 403(b)). In addition, under the Act, the limit under section 457 is coordinated with elective deferrals under a cash or deferred arrangement, a simplified employee pension, or a plan described in section 501(c)(18).

Explanation of Provision

An employee may participate in a section 457 plan of 1 employer and, for example, a cash or deferred arrangement of another employer. Thus, the employer maintaining the section 457 plan may not know whether an employee is making elective deferrals to a plan that is coordinated with the section 457 plan for purposes of the limit on deferred compensation. Thus, it is not appropriate to disqualify the entire section 457 plan in such cases.

Accordingly, the bill provides that, for purposes of determining whether an unfunded deferred compensation plan is an eligible plan under section 457, the rule requiring coordination of the deferred compensation limit with other plans is disregarded. Of course, if the limit (as so coordinated) is exceeded, the deferral of income inclusion provided by section 457 does not apply to the excess; instead, the rules of section 457(f) apply to such excess.

In order to prevent avoidance of the limit on deferred compensation under a section 457 plan by, for example, the use of affiliated service groups or leasing arrangements, the bill provides that the Secretary's general regulatory authority to prevent avoidance of certain requirements (sec. 414(o)) applies to section 457 plans.

c. Effective date

Present Law

Under the Act, the requirements of section 457 do not apply to amounts deferred under a plan established by a nongovernmental tax-exempt employer with respect to an employee that (1) were deferred for taxable years beginning before January 1, 1987, or (2) are deferred for taxable years beginning after December 31, 1986, pursuant to an agreement between the employer and the employee that (a) was in writing on August 16, 1986, and (b) on August 16, 1986, provided for a deferral for each taxable year of a fixed amount or an amount determined pursuant to a fixed formula. This exception does not apply with respect to amounts deferred in a fixed amount or under a fixed formula (including a fixed formula under a plan that is in the nature of a defined benefit plan) for any taxable year ending after the date on which the amount or formula is modified after August 16, 1986. The Act was unclear as to whether a plan is required to satisfy the requirements of section 457 (i.e., be an eligible plan) in order to qualify for the grandfather.

Explanation of Provision

The bill clarifies that the grandfather rule applicable to unfunded deferred compensation arrangements of tax-exempt employers applies to all deferred compensation plans of tax-exempt employers that otherwise meet the requirements of the grandfather rule, without regard to whether the plans would be eligible deferred compensation plans within the meaning of section 457.

The bill also clarifies that the grandfather rule only applies to individuals who were covered under the plan and agreement on August 16, 1986. Thus, for example, the grandfather does not apply to a new employee hired after August 16, 1986, or an employee who was hired on or before such date, but who was not a participant in the deferred compensation plan until after August 16, 1986.

5. Deferred annuity contracts (sec. 111A(i) of the bill, sec. 1135 of the Reform Act, and sec. 72(u) of the Code)

Present Law

Under the Act, if any annuity contract is held by a person who is not a natural person (such as a corporation or trust), then the contract is not treated as an annuity contract for Federal income tax purposes and the income on the contract for any taxable year is treated as ordinary income received or accrued by the owner of the contract during the taxable year. In the case of a contract the nominal owner of which is a person who is not a natural person, but the beneficial owner of which is a natural person, the contract is treated as held by a natural person.

The provision does not apply to any annuity contract that (1) is acquired by the estate of a decedent by reason of the death of the decedent; (2) is held under a qualified plan (sec. 401(a) or 403(a)), as a tax-sheltered annuity (sec. 403(b)) or under an IRA; (3) is a qualified funding asset for purposes of a structured settlement agreement (as defined in sec. 130(d), but without regard to whether there is a qualified assignment); (4) is purchased by an employer upon the termination of a qualified plan and is held by the employer until the employee separates from service; or (5) is an immediate annuity.

Explanation of Provision

The rule under which certain contracts will not be treated as annuity contracts was intended to apply for purposes of the Federal income taxation of the policyholder, but was not intended to extend to the tax treatment of the insurance company. Accordingly, the bill would clarify that the treatment of annuity contracts held by nonnatural persons applies generally for purposes of subtitle A of Title I of the Code, other than subchapter L.

The bill also provides that, with respect to the exception to the rule regarding treatment of annuity contracts held by nonnatural persons for an annuity that is purchased by an employer upon termination of a qualified plan, the exception applies to an annuity that is held until all amounts are distributed to the employee for whom such contract was purchased or to the employee's beneficiary.

6. Elective contributions under tax-sheltered annuities (sec. 111(c) of the bill, sec. 1105 of the Reform Act, and sec. 402 of the Code)

Present Law

The Act imposes a limit on elective deferrals under a tax-sheltered annuity that operates in the same manner as the limit on elective deferrals under a qualified cash or deferred arrangement. However, the annual limit on elective deferrals under a tax-sheltered annuity is $9,500 rather than $7,000. The $9,500 limit applies until the cost-of-living adjustments to the annual limit on elective deferrals under a qualified cash or deferred arrangement raise that limit from $7,000 to $9,500, at which time the limit on elective deferrals under a tax-sheltered annuity is also indexed at the same time and in the same manner as the indexing of the annual limit for elective deferrals under a qualified cash or deferred arrangement.

The Act provides an exception to the $9,500 annual limit (but not to the otherwise applicable exclusion allowance (sec. 403(b)) or the limit on contributions and benefits (sec. 415)) in the case of employees of an educational organization, a hospital, a home health service agency, a health and welfare service agency, a church, or a convention or association of churches. Under this exception, any eligible employee who had completed 15 years of service with the employer would be permitted to make an additional salary reduction contribution under the following conditions:

(1) In no year can the additional contributions be more than $3,000 (and, therefore, the $9,500 limit may not be increased above $12,500);

(2) An aggregate limit of $15,000 applies to the total amount of catch-up contributions (i.e., contributions that, in any year, exceed the limit on elective deferrals for that year); and

(3) In no event can this exception be used if an individual's lifetime elective deferrals exceed the individual's lifetime limit.

The lifetime limit on elective deferrals for an individual, solely for purposes of the special catch-up rule, is $5,000 multiplied by the number of years of service that the individual performed with the employer.

It is intended that the definition of years of service for purposes of the special catchup election will include principles similar to the principles of section 414(a). For this purpose, an employee's years of service will be determined by including all years of service with a predecessor employer (within the meaning of sec. 414(a)). Thus, years of service with a denomination of a church that merges into or combines with another denomination generally are to be aggregated with years of service with the surviving denomination.

Explanation of Provision

The Act does not specify how years of service are to be determined for purposes of the catch-up rule. The bill provides that, for this purpose, years of service are defined as in section 403(b). This definition will provide consistency with the way years of service are generally calculated under the rules relating to tax-sheltered annuities.

It is recognized that it may be difficult for employers to calculate the lifetime limit on elective deferrals for purposes of the catch-up rule because employers may not have records for prior years with respect to the portion of contributions to tax-sheltered annuities that were elective deferrals. Accordingly, under the bill, for purposes of calculating the lifetime limit under the catch-up rule, elective deferrals for prior years are to be determined in the manner prescribed by the Secretary. Under this provision, it is expected that the Secretary will provide administrable methods that employers can use to calculate elective deferrals for prior years.

7. Special rules for simplified employee pensions (sec. 111(f) of the bill, sec. 1108 of the Reform Act, and sec. 408(k) of the Code)

a. Salary reduction SEPs

Present Law

Under the Act, employees who participate in a SEP are permitted to elect to have contributions made to the SEP or to receive the contributions in cash. If an employee elects to have contributions made on the employee's behalf to the SEP, the contribution is not treated as having been distributed or made available to the employee. In addition, the contribution is not treated as an employee contribution merely because the SEP provides the employee with such an election. Therefore, under the Act, an employee is not required to include in income currently the amounts the employee elects to have contributed to the SEP. Elective deferrals under a SEP are to be treated in the same manner as elective deferrals under a qualified cash or deferred arrangement and, thus, are subject to the $7,000 (indexed) cap on elective deferrals.

The Act provides that the tax treatment described above of the election to have amounts contributed to a SEP or received in cash is available only if at least 50 percent of the employees of the employer elect to have amounts contributed to the SEP. In addition, this exception to the constructive receipt principle is available for a taxable year only if the employer maintaining the SEP had 25 or fewer employees at all times during the prior taxable year.

In addition, under the Act, the amount eligible to be deferred as a percentage of each highly compensated employee's compensation (i.e., the deferral percentage) is limited by the average deferral percentage (based solely on elective deferrals) for all nonhighly compensated employees who are eligible to participate. The deferral percentage for each highly compensated employee cannot exceed 125 percent of the average deferral percentage for all eligible nonhighly compensated employees.

If the 125-percent test is not satisfied, rules similar to the rules applicable to excess contributions to a cash or deferred arrangement are to apply.

Explanation of Provision

The bill clarifies that, for purposes of the rules relating to SEPs (other than sec. 408(k)(2)(C)), the uniform definition of compensation (sec. 414(s)) applies. The bill also clarifies that, for purposes of applying the 125-percent test to a salary reduction SEP, compensation does not include compensation in excess of $200,000.

The bill clarifies that, in determining whether the employer maintaining a salary reduction SEP had more than 25 employees in the prior taxable year, employees who were eligible to participate in the SEP (or would have been required to be eligible to participate if a SEP were maintained) are taken into account. This rule provides consistency with the eligibility rules for SEPs, that is, individuals who are not required to be eligible to participate in the SEP may be disregarded in determining whether the 25-employee rule is satisfied.

The bill adds provisions designed to ensure that excess contributions to a salary reduction SEP are distributed. These rules are somewhat different from the rules relating to excess deferrals in cash or deferred arrangements because, in the case of a SEP, the employer may not force an employee to take a distribution of excess deferrals because the SEP contributions are held in an IRA which the employee controls.

The bill specifically authorizes the Secretary to prescribe appropriate rules, including rules requiring that the excess contributions (plus income) be distributed, reporting requirements, and rules providing that contributions to a SEP (plus income) may not be withdrawn until a determination that the special nondiscrimination test has been satisfied is made. In addition, the bill provides that, until such a determination has been made, any transfer or distribution from a SEP of salary reduction contributions (or income on such contributions) is subject to tax in accordance with section 72 and to the early withdrawal tax (sec. 72(t)(1)), regardless of whether an exception to the tax would otherwise be available.

Consistent with the inclusion of SEP contributions that are made pursuant to a salary reduction agreement for purposes of FICA (sec. 3121(a)(5)) and FUTA (sec. 3306(b)(5)), the bill would include such contributions for purposes of determining benefits under the Social Security Act.

b. Integration rules

Present Law

The Act eliminated the prior-law rules under which nonelective SEP contributions could be combined with employer OASDI contributions for purposes of the applicable nondiscrimination requirements. In place of these rules, the Act permits nonelective SEP contributions to be tested for nondiscrimination under the new rules for qualified defined contribution plans permitting a limited disparity between the contribution percentages applicable to compensation below and compensation above the integration level. This provision is effective for years beginning after December 31, 1986. The new rules for defined contribution plans permitting a limited disparity between contribution levels are generally applicable to qualified plans for years beginning after December 31, 1988.

Explanation of Provision

The bill coordinates the effective date of the new integration rules with respect to qualified plans and SEPs. Thus, the bill provides that the integration rules applicable to SEPs (sec. 408(k)(3)(D) and (E)) prior to the Act will continue to apply to years beginning before January 1, 1989, when the new integration rules are effective. However, no integration is permitted under the 125-percent test.

c. Income exclusion

Present Law

Under present law, contributions to SEPs are excludable from income, rather than allowable as a deduction as under prior law.

Explanation of Provision

To conform to the conversion of the SEP deduction to an exclusion, the bill provides that, for purposes of section 408(d)(4), (5) and section 4973, an amount excludable from income under section 402(h) is treated as an amount allowable as a deduction under section 219.

d. Employer deduction

Present Law

Employer contributions to a SEP are deductible (1) in the case of a calendar year SEP, for the taxable year with or within which the calendar year ends, and (2) in the case of a SEP maintained on the basis of the taxable year of the employer, for such taxable year. The amount deductible in a taxable year for contributions to a SEP may not exceed 15 percent of the compensation paid to the employees during the calendar year ending with or within the taxable year.

Explanation of Provision

To take into account SEPs that are maintained on the basis of the employer's taxable year, the bill provides that, in the case of such SEPs, the 15 percent of compensation limitation applies to compensation paid during the employer's taxable year.

B. Nondiscrimination Requirements

1. Minimum coverage requirements (sec. 111(h) of the bill, sec. 1112 of the Reform Act, and sec. 410(b) of the Code)

Present Law

Under present law, a plan is not qualified unless it meets at least one of the following coverage requirements:

(1) the plan benefits at least 70 percent of all nonhighly compensated employees;

(2) the plan benefits a percentage of nonhighly compensated employees that is at least 70 percent of the percentage of highly compensated employees benefiting under the plan; or

(3) the plan meets the average benefits test, one requirement of which is that the average benefit percentage for nonhighly compensated employees be at least 70 percent of the average benefit percentage for highly compensated employees.

Explanation of Provision

The bill incorporates in the statute the provision in the Statement of Managers that a plan maintained by an employer that has no nonhighly compensated employees for a year is considered to satisfy the coverage requirements for such year. As is so with respect to the coverage rules generally, this rule is to apply separately with respect to former employees under rules prescribed by the Secretary.

2. Minimum participation rule (sec. 111(h) of the bill, sec. 1112 of the Reform Act, and sec. 401(a)(26) of the Code)

Present Law

In general

Under present law, a plan is not a qualified plan unless it benefits no fewer than the lesser of (a) 50 employees of the employer, or (b) 40 percent of all employees of the employer. This requirement may not be satisfied by aggregating comparable plans. Also, this requirement applies on an employer-wide basis and may not be satisfied on a line of business or operating unit basis.

Sanction

If a plan ceases to be qualified because of this minimum participation rule, it is subject to the generally applicable sanctions, one of which is that employer contributions made to the trust during the corresponding taxable year of the employer are includible in employees' incomes under rules applicable to nonqualified arrangements (sec. 83). Under present law, in the case of a plan that fails to be qualified solely because it does not satisfy the coverage requirements (sec. 410(b)), the employee's vested accrued benefit (other than employee contributions), to the extent that such amount has not been previously taxed to the employee, is includible in income, rather than the employer's contribution for the year. Also, nonhighly compensated employees are not taxable on amounts contributed to or earned by the trust merely because a plan fails to satisfy the coverage requirements.

Special transition rule

For purposes of the coverage rules, but not the minimum participation rule, a special transition rule applies in the case of certain dispositions or acquisitions of a business (sec. 410(b)(6)(C)).

Reversion tax and interest rate

The minimum participation rule is generally effective for plan years beginning after December 31, 1988.

Under a special rule, if (1) a plan is in existence on August 16, 1986, (2) the plan would fail to meet the requirements of the minimum participation rule if such rule were in effect on August 16, 1986, and (3) there is no transfer of assets to or liabilities from the plan, or merger or spinoff involving the plan, after August 16, 1986, that has the effect of increasing the amount of assets available for an employer reversion, such plan may be terminated or merged prior to the first plan year to which the minimum participation rule applies and the 10-percent excise tax on the reversion of assets (sec. 4980) will not be imposed on any employer reversion from such plan by reason of such termination or merger. Such a termination and reversion are permissible even though the terminating plan relies on another plan that is not terminated for qualification. In determining the amount of any such employer reversion, the present value of the accrued benefit of any highly compensated employee is to be determined by using an interest rate that is equal to the maximum interest rate that may be used for purposes of calculating a participant's accrued benefit under section 411(a)(11)(B). The Secretary is to prescribe rules preventing avoidance of this interest rate rule through distributions prior to or in lieu of a reversion.

Explanation of Provision

Sanction

The bill modifies the sanction applicable to a plan that ceases to be qualified based on a failure to satisfy either the minimum participation rule or the coverage rules. Under the bill, if a plan is not qualified and one of the reasons is the failure to satisfy the minimum participation rule or the coverage rules, any highly compensated employee is to include in income such employee's vested accrued benefit (other than such employee's investment in the contract). (This modification does not affect the application of the general rules of sec. 402(b)(1) regarding issues other than the amount includible in the year of disqualification, such as the application of sec. 72 to distributions from the disqualified plan.)

In addition, if a plan is not qualified solely because it does not satisfy either the minimum participation rule or the coverage rule or both, the bill provides that there is to be no inclusion in income by reason of such failure to qualify with respect to any employee who was not a highly compensated employee at any time during the trust year in which the plan became disqualified or during any prior year for which service was creditable to such employee under the plan (or a predecessor plan). For purposes of determining whether an employee was a highly compensated employee in any year, the definition of highly compensated employee applicable with respect to such year for purposes of the coverage rules is to apply.

Except for these changes, the sanctions applicable under present law, including the rules regarding the disallowance of an employer's deduction for contributions to a disqualified plan, continue to apply.

These modifications of the sanctions for disqualification are intended to fulfill the intent of the Act with respect to (1) ensuring that the disqualification sanction is adequate with respect to highly compensated employees, and (2) reducing the sanction with respect to nonhighly compensated employees in appropriate circumstances.

Applicability of affiliated service group and employee leasing rules

In order to prevent avoidance of the minimum participation rule, the bill provides that the affiliated service group rules (sec. 414(m)) and the employee leasing rules (sec. 414(n)) apply for purposes of the minimum participation rule. The bill further clarifies that the Secretary's general regulatory authority to prevent avoidance of certain requirements (sec. 414(o)) applies to the minimum participation rule.

Special transition rule

Under the bill, the special transition rule applicable in the case of certain dispositions or acquisitions of a business (sec. 410(b)(6)(C)) is to apply to the minimum participation rule. This is intended to prevent the minimum participation rule from disrupting business transactions by allowing a grace period following certain transactions for the new entities to comply with the minimum participation rule.

Reversion tax and interest rate

With respect to the rule under present law regarding the exemption from the reversion tax in the case of the termination or merger of certain plans not satisfying the minimum participation rule, the interest rate required to be used in determining the accrued benefit of any highly compensated employee and the corresponding reversion to the employer will in many cases understate the value of the employee's accrued benefit and thus represent a cutback in the employee's accrued benefit. In order to avoid this result, the bill modifies the rule referred to above in several respects.

First, the bill clarifies that for purposes of determining the amount to be distributed from a plan to an employee, the value of an employee's accrued benefit is not to be affected by this transitional rule regarding the minimum participation rule. Thus, for this purpose, the accrued benefit is to be determined under the interest rate used by the plan, if otherwise permissible under the Code.

Second, the bill provides a rule regarding the permissible interest rate to be used for certain purposes. The interest rate rule applies in the case of the termination or merger of a plan that (1) was in existence on August 16, 1986, and (2) would have failed to satisfy the requirements of the minimum participation rule had such rule been in effect on August 16, 1986. For this purpose, the term "termination or merger" is intended to include any similar transaction, such as a consolidation.

If the interest rate rule applies to a plan, the interest rate used in determining an "eligible amount" is to be no less than the highest of:

(1) the rate in effect under the plan on August 16, 1986, or if on August 16, 1986, the rate is determined under a formula (or other method), the rate determined under such formula (or other method);

(2) the highest rate used under the plan at any time after August 15, 1986, and before the termination or merger in calculating the present value of the accrued benefit of a nonhighly compensated employee under the plan (or any other plan used in determining whether the plan meets the requirements of sec. 401); or

(3) 5 percent.

For purposes of (1) above, the rate is to be determined without regard to any amendment adopted after August 16, 1986, even if such amendment is effective retroactively to apply on August 16, 1986.

The term "eligible amount" means the amount of any distribution with respect to a highly compensated employee that:

(1) may be rolled over under the applicable rules (sec. 402(a)(5));

(2) is eligible for income averaging (sec. 402(e)(1)) or grandfathered capital gains treatment; or

(3) may be transferred to another plan without inclusion in income.

In addition, if an annuity contract purchased after August 16, 1986, is distributed to a highly compensated employee by a plan to which the interest rate rule applies in connection with the termination or merger of such plan, the annuity contract is included in the employee's income to the extent of the excess of the purchase price of such contract over the present value of such contract using the lowest interest rate permitted in determining an eligible amount under the rules described above. However, such excess is to be disregarded for purposes of the early withdrawal tax (sec. 72(t)) and the excess distribution tax (sec. 4980A).

In the case of the termination or merger of a plan to which the interest rate rule applies, the excess (if any) of (1) the amount distributed to a highly compensated employee by reason of the termination or merger, over (2) the amount determined by using the lowest interest rate permitted in determining an eligible amount, also is disregarded for purposes of the early withdrawal tax and the excess distribution tax.

3. Vesting standards (sec. 111(i) of the bill and sec. 1113 of the Reform Act)

Present Law

Under present law, a plan (other than a multiemployer plan) is not qualified unless a participant's employer-provided benefit vests at least as rapidly as under 1 of 2 alternative schedules. A plan satisfies the first schedule if a participant has a nonforfeitable right to 100 percent of the participant's accrued benefit derived from employer contributions upon completion of 5 years of service. A plan satisfies the second schedule if a participant has a nonforfeitable right to at least 20 percent of the participant's accrued benefit derived from employer contributions after 3 years of service, 40 percent at the end of 4 years of service, 60 percent at the end of 5 years of service, 80 percent at the end of 6 years of service, and 100 percent at the end of 7 years of service.

In the case of a multiemployer plan, a participant's accrued benefit derived from employer contributions is required to be 100-percent vested no later than upon the participant's completion of 10 years of service. This exception applies only to employees covered by the plan pursuant to a collective bargaining agreement.

Prior to the Act, special vesting rules applied to class-year plans. A class-year plan was a profit-sharing, money purchase, or stock bonus plan that provided for the separate vesting of employee rights to employer contributions on a year-by-year basis. The minimum vesting requirements were satisfied under prior law if the plan provided that a participant's rights to amounts derived from employer contributions with respect to any plan year were nonforfeitable not later than the close of the fifth plan year following the plan year for which the contribution was made.

The imposition of the new vesting rules described above, including the repeal of class-year vesting, generally apply to plan years beginning after December 31, 1988, with respect to participants who have at least 1 hour of service after the effective date.

Explanation of Provision

The repeal of class-year vesting was not intended to adversely affect the vesting status of any participant. To fulfill this intent, the bill provides a special rule applicable to plans that after October 22, 1986, used class-year vesting. Whether a plan falls within this category is to be determined without regard to any amendment adopted after October 22, 1986, eliminating class-year vesting.

Plans that fall within the above category are to apply a special rule to any employee that has an hour of service (1) before the adoption of any amendment eliminating class-year vesting, and (2) on or after the first day of the first plan year for which the repeal of class-year vesting is applicable to such employee with respect to the plan. Under this special rule, for the year described in (2) above and any subsequent year, the employee's nonforfeitable right to the employee's accrued benefit derived from employer contributions is to be determined under the class-year vesting schedule that was eliminated if such schedule would yield a larger nonforeitable right than the new vesting schedule.

4. Application of nondiscrimination rules to integrated plans (sec. 111(g) of the bill, sec. 1111 of the Reform Act, and secs. 401(a)(5) and (l) of the Code)

Present Law

Under present law, a plan is not considered discriminatory merely because contributions or benefits of, or on behalf of, the employees under the plan favor highly compensated employees through permissible integration of the plan. In general, in the case of a defined contribution plan, whether integration is permissible is determined by comparing contributions with respect to compensation above the integration level with contributions with respect to compensation up to the integration level. In the case of a defined benefit excess plan, the rules apply to benefits, rather than contributions, with respect to compensation above and below the integration level.

In the case of a defined benefit excess plan, certain special tests apply if the integration level is above covered compensation. For this purpose, the term "covered compensation" means, with respect to an employee, the average of the taxable wage bases in effect for each year during the 35-year period ending with the year the employee attains age 65, assuming no increase in such wage base for years after the current year and before the employee actually attains age 65.

An integrated defined benefit plan is required to base benefits on average annual compensation.

Explanation of Provision

The bill clarifies that generally it is only employer-provided contributions and benefits that are taken into account in determining whether the contributions or benefits with respect to compensation above and below the integration level satisfy the integration rules.

To fulfill Congressional intent to conform certain qualified plan rules to the social security system, the bill modifies the definition of "covered compensation," so that the references to age 65 are replaced by social security retirement age (sec. 415(b)(8)), which can be between age 65 and age 67, depending on the date of birth of the employee.

The bill also clarifies that "average annual compensation" means the participant's highest average annual compensation for any period of at least 3 consecutive years (or, if shorter, the participant's full period of service). Thus, defined benefit plans providing benefits based on career average compensation are not prevented from integrating.

5. Definitions of highly compensated employee and of line of business (sec. 111(j) and (k) of the bill, secs. 1114 and 1115 of the Reform Act, and sec. 414(q) and (r) of the Code)

Present Law

Highly compensated employee

In general

In general, under present law, an employee, including a self-employed individual, is treated as highly compensated with respect to a year if, at any time during the year or the preceding year, the employee (1) was a 5-percent owner of the employer (as defined in sec. 416(i)); (2) received more than $75,000 in annual compensation from the employer; (3) received more than $50,000 in annual compensation from the employer and was a member of the top-paid group (generally, the top 20 percent by compensation) during the same year, or (4) was an officer of the employer (generally, as defined in sec. 416(i)).

Treatment of family members

Present law provides a special rule for the treatment of family members of certain highly compensated employees. Under the special rule, if an employee is a family member of either a 5-percent owner or 1 of the top 10 highly compensated employees by compensation, then any compensation paid to such family member and any contributions or benefits under the plan on behalf of such family member are aggregated with the compensation paid and contributions or benefits on behalf of the 5-percent owner or the highly compensated employee in the top 10 employees by compensation. Therefore, such family member and employee are treated as a single highly compensated employee.

An individual is considered a family member if, with respect to an employee, the individual is a spouse, lineal ascendant or descendant, or spouse of a lineal ascendant or descendant of the employee.

Even if a family member is excluded for purposes of determining the number of employees in the top-paid group (as discussed below), such family member is subject to the aggregation rule.

Top-paid group

The top-paid group of employees includes all employees who are in the top 20 percent of the employer's workforce on the basis of compensation paid during the year. For purposes of determining the size of the top-paid group (but not for identifying the particular employees in the top-paid group), the following employees may be excluded: (1) employees who have not completed 6 months of service; (2) employees who normally work less than 17½ hours per week; (3) employees who normally work not more than 6 months during any year; (4) except to the extent provided in regulations, employees who are included in a unit of employees covered by a collective bargaining agreement; (5) employees who have not attained age 21; and (6) employees who are nonresident aliens and who receive no United States-source earned income. An example of an instance in which it is appropriate to consider employees covered by a collective bargaining agreement is the case in which the plan being tested is maintained pursuant to a collective bargaining agreement.

For purposes of this special rule, an employer may elect to apply numbers (1), (2), (3), and (5) above by substituting any shorter period of service or lower age than is specified in (1), (2), (3), or (5), as long as the employer applies the test uniformly for purposes of determining its top-paid group with respect to all its qualified plans and employee benefit plans and for purposes of the line of business or operating unit rules described below.

Line of business or operating unit rules

Generally, if an employer is treated as operating separate lines of business or operating units for a year, the employer may apply the new coverage rules applicable to qualified plans and the new nondiscrimination rules applicable to statutory employee benefit plans separately to each separate line of business or operating unit for that year.

Under a special rule, a line of business or operating unit will not be treated as separate unless it satisfies certain requirements, one of which is that the line of business or operating unit have at least 50 employees.

Explanation of Provision

Highly compensated employees

Indexing

The bill provides that the $50,000 and $75,000 amounts are to be adjusted at the same time and in the same manner as the dollar limit applicable to defined benefit plans (sec. 415(d)). Such adjustments will prevent the definition of "highly compensated employee" from becoming inappropriate by virtue of inflation.

Nonresident aliens

In addition, under the bill, nonresident aliens who receive no United States-source earned income from the employer are to be disregarded for all purposes in determining the identity of the highly compensated employees of the employer. This modification will simplify the application of the rules and will prevent employees who are disregarded for purposes of the nondiscrimination rules from affecting the identity of the highly compensated employees.

Treatment of family members

The bill clarifies the applicability of the special rule for family members of certain highly compensated employees. The rule generally is to be used in applying any provision that refers to the definition of highly compensated employee (e.g., secs. 89, 401(a)(4), 401(a)(5), 401(k), 401(1) (through sec. 401(a)(5)), 401(m), 403(b)(12) (by reference to 401(a)(4), etc.), 408(k), 410(b)). Thus, the special rule does not apply for purposes of, for example, the limits on contributions or benefits (sec. 415) or the $7,000 limit on elective deferrals (sec. 402(g)). In addition, the bill provides the Secretary with regulatory authority to prevent the application of the special family member rule to inappropriate, clearly unintended situations. This regulatory authority is only to be used, however, in a manner consistent with the general policy underlying the family member rule, i.e., that, for purposes of all rules relating to nondiscrimination (or deductibility), the members of the family constitute one economic unit and thus are to be treated as one employee.

The bill also clarifies that the special family member rule applies for purposes of the $200,000 limit on the amount of compensation that may be taken into account under a qualified plan (for qualification or deduction purposes) or under an employee benefit plan (secs. 89, 401(a)(17), and 404(1)). However, for this purpose, the definition of a family member is modified to refer only to the employee's spouse and children of the employee who do not attain age 19 by the close of the year.

For example, assume that employee A of employer X receives compensation (as defined under sec. 414(s)) of $275,000 and is the highly compensated employee with the highest compensation from X. A's spouse (B), adult child (C), and 17-year old child (D) also are employees of X. B, C, and D receive $100,000, $225,000, and $10,000 of compensation (as defined under sec. 414(s)), respectively. X maintains a qualified cash or deferred arrangement (sec. 401(k)) under which A, B, C, and D are eligible. A, B, and C each defers $7,000 under the arrangement; D makes no deferral.

For purposes of applying the special nondiscrimination test applicable to the arrangement (sec. 401(k)(3)), A, B, C, and D are treated as 1 employee. The compensation of this "1 aggregated employee" is determined as follows: A, B, and D are combined and limited to $200,000 (rather than the $385,000 they actually receive). The $200,000 limit applies separately to C because, under the special definition of a family member for purposes of the $200,000 limit, C is not a family member of A, B, or D. Thus, the compensation taken into account for the aggregated employee is $200,000 (for A, B, and D) plus $200,000 (for C) for a total of $400,000. The total deferrals for this aggregated employee are $21,000. Thus, for purposes of applying the special nondiscrimination test to the cash or deferred arrangement, A, B, C, and D are treated as a single employee with a deferral percentage of $21,000/$400,000 or 5.25 percent. Since the family aggregation rule does not apply for purposes of the $7,000 limit on elective deferrals (sec. 402(g)), none of the family members is considered to have exceeded such limit.

The bill further clarifies the application of the special family member rule to the integration rules under section 401(1). Although the special family member rule generally applies for purposes of section 401(l), it does not apply in determining the amount of compensation below the plan's integration level except that the total of the compensation below the integration level is subject to the $200,000 limit (sec. 401(a)(17)). Thus, for example, assume the same facts described in the above example, except that instead of maintaining a qualified cash or deferred arrangement, X maintains an integrated, nonelective profit-sharing plan with an integration level of $43,800. Again, the compensation of the aggregated employee is $400,000. Of that $400,000, a total of $141,400 is considered to be below the integration level (i.e., $43,800 each attributable to A, B, and C, and $10,000 attributable to D).

Line of business or operating unit rules

Under the bill, the Secretary is to prescribe rules providing certain minimum standards regarding the age and service requirements that are to apply for purposes of determining which employees are taken into account in determining if a line of business or operating unit may be treated as separate. (The standards are to apply, for example, for purposes of determining if a line of business or operating unit has 50 employees.) Under this authority, the Secretary could provide that, for such purpose, section 414(q)(8) is to be applied without regard to the last sentence thereof, i.e., the employer may not elect to reduce the age or service requirements specified in the statute.

The primary purpose for this provision of the bill is to prevent the use of nominal age or service requirements to avoid the effect of the requirement that, to be treated as separate, a line of business or operating unit is to have 50 employees.

6. Definition of compensation (sec. 111(k) of the bill, sec. 1115 of the Reform Act, and sec. 414(s) of the Code)

Present Law

Under present law, except as otherwise provided, "compensation" is defined as compensation for services for an employer that is includible in gross income. The Secretary is to prescribe regulations defining compensation for a self-employed individual based on this definition applicable to common-law employees.

The employer may elect whether to include elective deferrals (under secs. 125, 402(a)(8), 402(h), or 403(b)) as part of compensation. In addition, the Secretary is directed to provide certain alternative definitions of compensation that do not favor highly compensated employees.

An employee who at any time during the plan year or any of the 4 preceding plan years is a 1-percent owner of the employer and has annual compensation from the employer of more than $150,000 is a key employee.

Explanation of Provision

The bill modifies the general definition of compensation so that it is the same one used (for employees or self-employed individuals, whichever is applicable) for purposes of the limit on contributions under a defined contribution plan (sec. 415(c)(3)). (The bill does not affect the employer's right to elect to include elective deferrals or the Secretary's authorization to provide alternative definitions of compensation.) This provides greater uniformity, and excludes certain items (such as deductible reimbursements of moving expenses) that were not intended to be taken into account. It is not the intent of the bill, however, to restrict future regulatory modifications of the definition of compensation under section 415(c)(3).

The bill also clarifies that the definition of compensation provided in section 414(s) only applies to provisions that specifically refer to it. Thus, for example, the definition does not apply for purposes of the limits on deductions (sec. 404) or on contributions and benefits (sec. 415).

Under the bill, for purposes of determining whether an employee is a key employee by virtue of having annual compensation over $150,000, compensation means compensation as defined in section 415(c)(3) plus elective deferrals under sections 125, 402(a)(8), 402(h), and 403(b). This is the same definition used for purposes of determining whether an employee is highly compensated (sec. 414(q)(7)), a determination that is similar to the determination of who is a key employee. This provision of the bill applies to years beginning after December 31, 1988.

C. Treatment of Distributions

1. Uniform minimum distribution rules (sec. 111A(a) of the bill, sec. 1121 of the Reform Act, and secs. 402(a)(5), 402(e)(1)(B), and 408(d)(3)(A) of the Code)

Present Law

Under present law, a uniform benefit commencement date and required distribution rules are provided for benefits under all qualified plans (secs. 401(a) and 403(a)), IRAs (sec. 408), tax-shelterd annuities (sec. 403(b)), and eligible deferred compensation plans of State and local governments and tax-exempt employers (sec. 457 plans).

The Act repealed the provisions that prohibited rollover distributions by or on behalf of 5-percent owners to another qualified plan. However, the Act did not repeal the provision that prohibited a 5-percent owner from rolling over a qualified plan distribution into a conduit IRA and subseqently rolling the distribution over into another qualified plan.

Explanation of Provision

The bill clarifies that a distribution from a qualified plan and corresponding distribution to an IRA that results in any portion of a distribution being excluded from gross income under the rollover provisions is treated as a rollover distribution for purposes of the IRA rollover provisions.

The bill deletes the IRA rollover restriction under which certain distributions from IRAs with respect to 5-percent owners are not treated as rollover distributions for purposes of the IRA rules. This provision is effective for rollover distributions made in taxable years beginning after December 31, 1986. Thus, the bill clarifies that, as is the case with other taxpayers, 5-percent owners may roll over a qualified plan distribution into an IRA and subsequently roll the amount distributed from the IRA into another qualified plan. Different rules for 5-percent owners and other taxpayers are no longer necessary under the Act because all distributions from qualified plans are generally subject to the early withdrawal tax formerly applicable only to distributions to 5-percent owners.

Further, the bill provides that, notwithstanding any other provision of law, a plan or contract is permitted (except as provided in regulations prescribed by the Secretary) to incorporate by reference the uniform benefit commencement date and the required distribution rules for qualified plans (sec. 401(a)(9)).

It is further intended that an employee who has not retired from an employer prior to 1989, but has attained age 70½ prior to 1989, is considered to have attained age 70½ in 1989 for purposes of applying the new uniform benefit commencement rule to a plan maintained by the employer.

2. Tax treatment of distributions (sec. 111A(b) of the bill, sec. 1122 of the Reform Act, and secs. 72, 402, and 414 of the Code)

The Act generally (1) phased out long-term capital gains treatment over 6 years (except for certain grandfathered individuals); (2) eliminated 10-year forward averaging (except for certain grandfathered individuals) and allowed 5-year forward averaging under more limited circumstances; (3) modified the prior-law basis recovery rules for amounts distributed prior to a participant's annuity starting date; (4) repealed the special 3-year basis recovery rule; (5) modified the general basis recovery rules for distributions from an annuity; (6) provided basis recovery rules for distributions from an IRA when an individual has made nondeductible IRA distributions; (7) repealed the constructive receipt rule for tax-sheltered annuities; and (8) modified the rules relating to rollovers of partial distributions.

a. Basis recovery rules

Present Law

The Act modified the basis recovery rules applicable to distributions from plans to which after-tax employee distributions have been made by (1) eliminating the 3-year basis recovery rule for distributions on or after the annuity starting date, and (2) requiring, with respect to distributions prior to the annuity starting date, that basis be recovered on a pro-rata basis.

Further, present law limits the total amount that an employee may exclude from income as a recovery of basis to the total amount of the employee's basis. If benefits cease prior to the date the basis has been fully recovered, the amount of unrecovered basis is allowed as a deduction to the annuitant for his or her last taxable year. These modifications of the basis recovery rules are effective with respect to an individual whose annuity starting date is after July 1, 1986.

Under the Act, employee contributions to a defined contribution plan (and the income attributable thereto) may be treated as a separate contract for purposes of the basis recovery rules.

Under present law, a special basis recovery rule applies with respect to a plan substantially all the contributions to which are employee contributions (sec. 72(e)(7)). Under this special rule, distributions from such a plan are treated first as a return of taxable amounts under the plan.

Explanation of Provision

The bill provides that, if employee contributions (and the income attributable thereto) under a defined benefit plan are credited to a separate account that generally is treated as a defined contribution plan (sec. 414(k)), then such separate account is also treated as a defined contribution plan for purposes of the basis recovery rules. The bill clarifies that this separate contract treatment applies without regard to whether the distribution is received as an annuity.

The bill repeals the special basis recovery rules that apply in the case of a plan substantially all of the contributions to which are employee contributions.

The bill provides that the effective date of the provision allowing a deduction in the last taxable year of the annuitant for unrecovered basis is effective for individuals whose annuity starting date is after July 1, 1986. Thus, in the case of an individual whose annuity starting date is after July 1, 1986, and before January 1, 1987, the rule limiting the amount of basis recovered does not apply, but the rule providing a deduction at death for unrecovered basis does apply. This rule is provided because individuals who lost the benefit for the 3-year basis recovery rule did not have adequate time to consider alternative forms of retirement benefits and it would be unfair to deny such individuals the benefit of the deduction for unrecovered basis at death.

The bill provides a special rule with respect to plans maintained by a State that, on May 5, 1986, provided for withdrawals to the employee of employee contributions (other than as an annuity). In the case of such plans, the modifications in the basis recovery rules for distributions prior to the annuity starting date apply only to the extent that the amount distributed exceeds the employee's basis as of December 31, 1986. In addition, amounts received (other than as an annuity) before or with the first annuity payment are treated as having been recovered before the annuity starting date.

b. Rollovers

Present Law

The Act modified the rules relating to rollovers of partial distributions. Under the Act, partial distributions may be rolled over only if the distribution would satisfy the requirements for a lump-sum distribution and if the distribution is made on account of the death of the employee, the employee's separation from service, or is made after the employee has become disabled. The rule aggregating plans of the same kind applies for purposes of determining whether the amount distributed constitutes 50 percent of the balance to the credit of an employee (sec. 402(e)(4)(C)).

The Act contained a special rule permitting certain amounts deposited in certain financially distressed financial institutions to be rolled over notwithstanding that the rollover does not occur within 60 days of the date of the original distribution. Under this rule, the 60-day period does not include periods while the deposit is frozen. In addition, the individual has a minimum of 10 days after the release of the frozen deposit to complete the rollover.

Explanation of Provision

The bill clarifies that a partial distribution may be rolled over only if the distribution would satisfy the requirements for a lump-sum distribution if at least 50 percent of the balance to the credit of an employee is used rather than the balance to the credit of the employee in applying the test for lump-sum distribution treatment.

For purposes of determining whether a partial distribution may be rolled over, the 5 years of participation and the election requirements applicable to lump-sum distributions do not apply (secs. 402(e)(4)(B) and (H)).

The bill clarifies that the special rule for frozen deposits applies only to amounts that are frozen within 60 days of the date that the amounts are distributed from the plan.

c. Net unrealized appreciation

Present Law

Under present law, to the extent provided by the Secretary, a taxpayer may elect to waive the special treatment of net unrealized appreciation in employer securities with respect to a lump-sum distribution prior to the time the distribution is received.

Explanation of Provision

Under the bill, the election to waive net unrealized appreciation treatment with respect to a lump-sum distribution is to be made on the tax return on which the distribution is required to be included in gross income if the special treatment is waived. This change is designed to give taxpayers more time to determine whether or not they make the election. An election to waive the special treatment of net unrealized appreciation does not preclude an election for income averaging.

d. Income averaging and long-term capital gains treatment

Present Law

The Act generally repealed 10-year forward averaging, phased out pre-1974 capital gains treatment over a 6-year period, and made 5-year forward averaging (calculated in the same manner as 10-year averaging under prior law) available for 1 lump-sum distribution with respect to an employee on or after the taxpayer attains age 59½.

In addition, the Act provided a special transition rule under which an individual who had attained age 50 by January 1, 1986, is entitled to make 1 election to use 5-year averaging (under the new tax rates) or 10-year averaging (under the prior-law tax rates) with respect to a single lump-sum distribution. Similarly, such a grandfathered individual could elect capital gains treatment with respect to a lump-sum distribution without regard to the 6-year phaseout of capital gains treatment. Under this special capital gains election, the portion of a lump-sum distribution entitled to capital gains treatment is taxed at a rate of 20 percent, regardless of the maximum effective capital gains rate under prior law.

Under prior law, the amount subject to tax under the income averaging rule was calculated by adding in the zero bracket amount. This addition was eliminated by the Act because the zero bracket amount is eliminated generally.

Explanation of Provision

The bill clarifies that a 5-year averaging election may be made by an individual, trust, or estate for a lump-sum distribution received with respect to an employee who had attained age 59½. In addition, the bill provides that an income averaging election or election of long-term capital gains treatment under the special transition rules may be made by any individual, trust, or estate with respect to an employee who had attained age 50 by January 1, 1986.

The bill also clarifies that, for purposes of 5-year income averaging, the phaseout of the 15-percent bracket applies.

Further, under the bill, the election under the special transition rule of 10-year averaging (under the prior-law tax rates) is to take into account the prior-law zero bracket amount. This change is needed to preserve the prior-law treatment for persons who elect the grandfather rule.

The bill clarifies that a capital gains election made under either of the special transition rules is treated as an income averaging election (within meaning of sec. 402(e)(4)(B)) for all purposes under the Code (including, of example, sec. 4980A relating to the 15-percent tax on excess distributions).

3. Additional income tax on early withdrawals (sec. 111A(c) of the bill, sec. 1123 of the Reform Act, and sec. 72 of the Code)

The Act (1) modified the withdrawal restrictions applicable to qualified cash or deferred arrangements, tax-sheltered annuities, and tax-sheltered custodial accounts, and (2) imposed a 10-percent additional income tax on certain early withdrawals from qualified retirement plans.

A qualified retirement plan is defined to include (1) a qualified plan (sec. 401(a)), (2) a qualified annuity plan (sec. 403(a)), (3) a tax-sheltered annuity or custodial account (sec. 403(b)), or (4) an individual retirement arrangement (IRA) (sec. 408).

a. Early retirement exception

Present Law

Under the Act, the additional income tax on early withdrawals does not apply to distributions that are made to an employee after separation from service on account of early retirement under the plan after attainment of age 55. This exception does not apply to distributions from an IRA.

In all cases, the exception applies only if the participant has attained age 55 on or before separation from service. Thus, for example, the exception does not apply to a participant who separates from service at age 52 and begins receiving benefits at or after age 55.

Explanation of Provision

The bill modifies the early retirement exception to apply in any case in which an employee receives a distribution on account of separation from service after attainment of age 55, rather than requiring an early retirement under the plan. The intent of this provision is to eliminate what is considered a requirement that has little substantive effect, but could require plan amendment.

The modified early retirement exception continues to apply if the employee returns to work for the same emloyer (or for a different employer) as long as the employee did, in fact, separate from service before the plan distribution. Of course, any short-term separation is to be closely scrutinized to determine if it is a bona fide, indefinite separation from service that would qualify for this exception to the early withdrawal tax.

As under present law, this exception does not apply to IRA distributions.

b. Exception for distributions from ESOPs

Present Law

Under present law, certain contributions from an employee stock ownership plan (ESOP) are exempt from the additional income tax on early withdrawals. Under the Act, this exception applies to the extent that, on average, a majority of assets in the plan have been invested in employer securities for the 5-plan year period preceding the plan year in which the distribution is made and the exception does not apply to any distribution attributable to assets that have not been invested in employer securities at all times during such 5-plan year period.

Explanation of Provision

The bill modifies the ESOP exception to the additional income tax on early withdrawals to provide that the exception is available to the extent that a distribution from an ESOP is attributable to assets that have been invested, at all times, in employer securities (as defined in sec. 409(l)) that satisfy the requirements of sections 409 and 401(a)(28) for the 5-plan year period immediately preceding the plan year in which the distribution occurs. Employer securities that are transferred to an ESOP from another plan are also eligible for the exception to the early withdrawal tax as long as the holding period requirement is satisfied with respect to such employer securities taking into account the time such employer securities were held in the other plan.

For example, assume that employer securities that were transferred from a profit-sharing plan are held in an ESOP for the 1-plan year period immediately preceding the plan year in which the distribution is made. If the profit-sharing plan met the requirements of sections 401(a)(28) and 409 for the 4-plan year period immediately prior to the transfer to the ESOP, then the holding period requirement is satisfied. On the other hand, if the profit-sharing plan did not satisfy sections 401(a)(28) and 409, the holding period requirement would not be satisfied and the exception to the early withdrawal tax does not apply. The bill clarifies that the employer securities are not required to be subject to the requirements of sections 401(a)(28) and 409 prior to the time those requirements are effective.

These changes are designed to ensure that the ESOP exception only applies with respect to employer securities that are subject to the rules applicable to ESOPs.

Under the bill, an ESOP includes both an ESOP described in section 4975(e)(7) and a tax-credit ESOP (within the meaning of sec. 409).

c. Exceptions not applicable to IRAs

Present Law

Under present law, certain exceptions to the additional income tax on early withdrawals are not applicable to distributions from IRAs. These exceptions include the early retirement, medical expense, and ESOP exceptions. The exception for distributions pursuant to a qualified domestic relations order applies to an IRA only to the extent the IRA is subject to the rules relating to qualified domestic relations orders.

Explanation of Provision

Because the rules relating to qualified domestic relations orders do not apply to IRAs, the bill clarifies that the exception to the early withdrawal tax in the case of distributions pursuant to a qualified domestic relations order does not apply to IRA distributions. This is consistent with the pre-Reform Act law applicable to IRAs.

d. Deferred annuity contracts

Present Law

Under present law, early withdrawals from a deferred annuity contract generally are subject to a 10-percent additional income tax in the same manner as early withdrawals from a qualified plan.

Certain exception to the 10-percent early withdrawal tax are provided. An exception is provided for a distribution that is part of a series of substantially equal periodic payments (not less frequently than annually) made over the life or life expectancy of the taxpayer or the lives or life expectancies of the taxpayer and the taxpayer's beneficiary.

If distributions to an individual are not subject to the tax because of application of the substantially equal payment exception, the tax will nevertheless be imposed if the employee changes the distribution method prior to age 59½ to a method that does not qualify for the exception. The additional tax will be imposed in the first taxable year in which the modification is made and will be equal to the tax (as determined under regulations) that would have been imposed had the exception not applied.

In addition, the recapture tax will apply if an employee does not receive payments under a method that qualifies for the exception for at least 5 years, even if the method of distribution is modified after the employee attains age 59½. Thus, for example, if an employee begins receiving payments in substantially equal installments at age 56, and alters the distribution method to a form that does not qualify for the exception prior to attainment of age 61, the additional tax will be imposed on amounts distributed prior to age 59½ as if the exception had not applied. The additional tax will not be imposed on amounts distributed after attainment of age 59½.

The modifications to the additional income tax on early withdrawals under a deferred annuity apply to all distributions made under the annuity in taxable years beginning after December 31, 1986.

Explanation of Provision

The bill clarifies that the substantially equal payment exception and the recapture tax for distributions in violation of the substantially equal payment exception are not limited to distributions to employees under an employer-maintained pension plan. Rather, the exception and recapture tax apply to all distributions under a deferred annuity whether or not received by an individual with respect to the individual's status as an employee.

Further, the bill clarifies that the additional income tax applicable to early withdrawal from a deferred annuity (sec. 72(q)) does not apply if a distribution is otherwise subject to the early withdrawal rules for qualified plans (sec. 72(t)), whether or not an exception to the additional income tax on early withdrawals from a qualified plan applies under section 72(t)(2).

The bill modifies the effective date of the provision relating to the additional income tax on early withdrawals under a deferred annuity so that the changes in the early withdrawal tax does not apply to any distribution under an annuity contract if (1) as of March 1, 1986, payments were being made under such contract pursuant to a written election providing a specific schedule for the distribution of the taxpayer's interest in such contract, and (2) such distribution is made pursuant to such written election.

e. Substantially equal payment exception

Present Law

Under present law, an exception to the 10-percent additional income tax on early withdrawals from a qualified plan or deferred annuity is provided for a distribution that is part of a series of substantially equal periodic payments made (not less frequently than annually) over the life or life expectancy of the taxpayer or the lives or life expectancies of the taxpayer and the taxpayer's beneficiary.

Explanation of Provision

The bill provides that the substantially equal payment exception is available only if the beneficiary whose life or life expectancy is taken into account in determining whether the exception is satisfied is a designated beneficiary of the individual. For this purpose, rules similar to those applicable under section 401(a)(9) are to apply.

f. Qualified voluntary employee contributions

Present Law

Under prior law, an employee who was a participant in a qualified plan, tax-sheltered annuity program, or government plan was allowed a deduction for qualified voluntary employee contributions (QVECs) made by or on behalf of the employee to the plan. The Act repealed the deduction allowed for QVECs, but permitted contributions that had been made prior to repeal to continue to be held under the plan.

Under present law, in addition to the additional income tax on early withdrawals under qualified plans (sec. 72(t)), a 10-percent additional income tax is also imposed on early withdrawals of QVECs (sec. 72(o)).

Explanation of Provision

In order to prevent the imposition of two 10-percent early withdrawal taxes on distributions attributable to QVECs, the bill repeals the 10-percent early withdrawal tax applicable only to QVECs. Thus QVECs are treated as distributions from a qualified plan for purposes of the 10-percent additional income tax on early withdrawals and are eligible for any of the applicable exceptions otherwise available for distributions from qualified plans.

g. Tax-sheltered annuities

Present Law

The Act provided that the withdrawal restrictions applicable to tax-sheltered custodial accounts generally were extended to elective deferrals and earnings on elective deferrals under other tax-sheltered annuities. Under these rules, early distributions from elective deferrals and earnings on elective deferrals under a tax-sheltered annuity are prohibited unless the withdrawal is made on account of death, disability, separation from service, or attainment of age 59½. In addition, withdrawals on account of hardship from a tax-sheltered annuity or custodial account are permitted only to the extent of the contributions made pursuant to a salary reduction agreement (but not earnings on those contributions).

Under the Act, the provisions restricting distributions attributable to elective deferrals (and earnings thereon) under a tax-sheltered annuity are effective for taxable years beginning after December 31, 1988.

Explanation of Provision

The bill provides that the distribution restrictions added by the Act with respect to tax-sheltered annuities are effective for years beginning after December 31, 1988, but only with respect to distributions from such tax-sheltered annuities that are attributable to assets that were not held as of the close of the last year beginning before January 1, 1989. Thus, the new rules apply to contributions made in years beginning after December 31, 1988, and to earnings on those contributions and on amounts held as of the last year beginning before January 1, 1989.

h. Involuntary cashouts under a qualified plan

Present Law

Under present law, a pension plan may immediately distribute the present value of an employee's benefit under the plan if the employee separates from service with the employer and the present value of the benefit does not exceed $3,500. It was unclear under the Act whether the 10-percent additional income tax on early withdrawals under a qualified plan applies in the case of such involuntary cashouts of benefits.

Explanation of Provision

The bill clarifies that the additional income tax on early withdrawals under a qualified plan is to apply in the case of an involuntary cashout. Of course, the early withdrawal tax does not apply if the amount of the benefit paid to an employee is rolled over to another qualified plan or an IRA.

4. Transition rule (sec. 111A(d) of the bill and sec. 1124 of the Reform Act)

Present Law

Under the Act, a special transition rule was provided in the case of employees who separated from service during 1986. In the case of such an employee, if the employee received a lump-sum distribution before March 16, 1987, on account of the separation from service, then the employee could treat the lump-sum distribution as received in 1986 for all purposes. Thus, the lump-sum distribution is includible in income in 1986 and, assuming the employee is otherwise eligible, the employee can elect 10-year income averaging with respect to the lump-sum distribution.

Explanation of Provision

Under the bill, the special transition rule is amended to apply in the case of an employee who dies, separates from service, or becomes disabled at any time before 1987, including years prior to 1986. In the case of such an employee, if an individual, trust, or estate receives a lump-sum distribution with respect to the employee after December 31, 1986, and before March 16, 1987, on account of the employee's death, separation from service, or disability, then the individual, trust, or estate may treat the distribution as if it was received in 1986 for all purposes under the Code. This restructuring of the rule is intended to make it clear that (1) an individual, trust, or estate may elect the transition rule with respect to a lump-sum distribution received for an employee who otherwise would qualify for the transition rule and (2) a separation from service on account of death or disability is also a separation from service for purposes of the transition rule.

The bill also clarifies that, for purposes of the transition rule, the 5 years of participation requirement (sec. 402(e)(4)(H)) and the election requirement (sec. 402(e)(4)(B)) applicable to lump-sum distributions do not apply.

5. Loans from qualified plans (sec. 111A(h) of the bill, sec. 1134 of the Reform Act, and sec. 72(p) of the Code)

Present Law

Under present law, an individual is permitted to borrow from a qualified plan in which the individual participates (and to use his or her accrued benefit as security for the loan) if certain requirements are satisfied.

Subject to certain exceptions, a loan to a plan participant is treated as a taxable distribution of plan benefits under present law.

Present law provides for the disallowance of the deduction for interest paid on a loan from a qualified plan by (1) all employees on loans secured by elective deferrals (or the income attributable thereto) under a qualified cash or deferred arrangement or tax-sheltered annuity or custodial account, and (2) key employees with respect to loans from any qualified plan or tax-sheltered annuity or custodial account.

Explanation of Provision

Present law does not expressly prescribe the period during which the interest deduction disallowance rule applies. Therefore, the bill clarifies the period during which the interest deduction disallowance rule applies to include the period (1) on or after the first day on which the individual to whom a loan is made is a key employee or (2) the loan is secured by elective deferrals under a qualified cash or deferred arrangement or tax-sheltered annuity or custodial account.

D. Limits on Tax Deferral Under Qualified Plans

1. Overall limits on contributions and benefits under qualified plans (sec. 111(d) of the bill, sec. 1106 of the Reform Act, and secs. 404 and 415 of the Code)

The Act revised the overall limits on contributions and benefits under qualified plans, tax-sheltered annuity programs, and SEPs. In addition, the Act (1) provides special rules with respect to plans of governmental employers and tax-exempt employers, (2) permitted a defined benefit pension plan to maintain a qualified cost-of-living arrangement under which employer and employee contributions may be applied to provide cost-of-living increases to the primary retirement benefit under the plan, (3) imposed a limit on the amount of compensation that may be taken into account for deduction purposes, and (4) modified the rules relating to the phasein of the limits on annual benefits under a defined benefit pension plan.

a. Includible compensation

Present Law

Under present law, not more than $200,000 of compensation of an employee may be taken into account under a qualified plan. This $200,000 limit on includible compensation applies for most purposes under the Code, including the provisions relating to nondiscrimination requirements and to deductibility. Consequently, no more than $200,000 of an employee's compensation for a year may be taken into account in computing deductions for plan contributions.

This $200,000 limit is to be adjusted, beginning in 1990, for post-1988 cost-of-living increases at the time and in the manner provided for the adjustment of the limits on annual benefits under a qualified defined benefit pension plan (sec. 415(d)).

Explanation of Provision

Under the bill, increases in the $200,000 limit on includible compensation may not be taken into account before they occur in determining the deduction limit for contributions to a qualified plan. Similarly, such increases may not be taken into account before they occur in calculating the full funding limitation (as determined under sec. 412).

Further, the bill makes it clear that the $200,000 cap on includible compensation does not apply, under present law, in the case of an employer's deduction for benefits provided under a nonqualified deferred compensation plan.

b. Eligibility to receive maximum benefits

Present Law

Under the Act, a reduced dollar limit applies to participants who have completed fewer than 10 years of participation in a defined benefit pension plan (sec. 415(b)(5)). With respect to such participants, the dollar limit is determined by multiplying the otherwise applicable dollar limit by a fraction. The numerator of the fraction is the number of years (including a fractional year) of participation in the plan completed by the employee. The denominator of the fraction is 10.

The Act provides that, to the extent provided in regulations, the reduction based on years of participation is to be applied separately with respect to each change in the benefit structure of a plan by a plan amendment or otherwise as if such change is a new plan. This phasein for each change in benefit structure begins on the date a plan amendment creating the change is effective.

A separate phase-in rule applies to the 100-percent of compensation limit (sec. 415(b)(1)(B)) and to the $10,000 limit on de minimis benefits (sec. 415(b)(4)). Under this rule, those limits are phased in on the basis of years of service rather than years of participation.

Explanation of Provision

The bill clarifies that the rule requiring separate phaseins for each change in benefit structure under a plan does not apply in the case of the phasein of the 100 percent of compensation limit or the $10,000 limit on de minimis benefits.

c. Qualified cost-of-living arrangements

Present Law

In general

The Act permitted a defined benefit pension plan to maintain a qualified cost-of-living arrangement under which employer and employee contributions may be applied to provide cost-of-living increases to the primary benefit under the plan. If the arrangement is qualified, then an employee contribution under the arrangement is not to be treated as an annual addition in applying the separate limit on annual additions under defined contribution plans (sec. 415(c)), but is to be treated as an annual addition for purposes of applying the combined plan limit (sec. 415(e)). Further, under a qualified arrangement, the benefit attributable to an employee's contribution is to be treated as a benefit derived from employer contributions for purposes of applying the limit on annual benefits (sec. 415(b)). Under the Act, a qualified cost-of-living arrangement is required to comply with the dollar limits, election procedures, and nondiscrimination requirements of the Act.

Limit requirement

A qualified cost-of-living arrangement satisfies the limit requirement provided by the Act if it (1) limits cost-of-living adjustments to those cost-of-living increases occurring after the annuity starting date, and (2) bases the cost-of-living adjustment on average cost-of-living increases determined by reference to 1 or more indices prescribed by the Secretary, except that the plan can provide a minimum increase for each year of 3 percent of the original retirement benefit. It was unclear, under the Act, whether a plan could provide for a minimum increase for each year of 3 percent of the retirement benefit as adjusted under the cost-of-living arrangement in prior years.

Election requirement

A qualified cost-of-living arrangement meets the election requirements if it provides that participation in the qualified cost-of-living arrangement is elective and permits participants to make an election in (1) the year in which the participant attains the age at which retirement benefits are first available under the defined benefit pension plan; (2) the year in which the participant separates from service; or (3) both such years.

Explanation of Provision

Limit requirement

The bill clarifies that a plan will not fail to satisfy the limit requirement if it provides for a minimum increase for each year of 3 percent of the retirement benefit (determined without regard to the current year's increase). Thus, the minimum increase may be 3 percent of the retirement benefit as adjusted under the cost-of-living arrangement in prior years.

Election requirement

Under the bill, a plan may permit participants to make an election under the qualified cost-of-living arrangement during any year, as long as the plan permits elections to be made at least in the year in which the participant (1) attains the earliest retirement age under the defined benefit pension plan (determined without regard to any requirement of separation from service), or (2) separates from service.

d. Computation of combined limit

Present Law

Under a transition rule of the Act, in the case of a plan that satisfied the requirements of the overall limits on contributions and benefits (sec. 415) for its last year beginning before January 1, 1987, Treasury regulations are to provide for the determination of an amount that is to be subtracted from the numerator of the defined contribution fraction so that the sum of the defined benefit plan fraction and the defined contribution plan fraction (sec. 415(e)(1)) does not exceed 1.0 for such year. This amount to be subtracted is not to exceed the numerator of the fraction.

Explanation of Provision

The bill clarifies that the adjustment to the sum of the defined benefit plan fraction and the defined contribution fraction so that such sum does not exceed 1.0 for purposes of this transition rule is determined as if the new rules were in effect for the last year beginning before January 1, 1987.

2. Deduction limits for qualified plans (sec. 111A of the bill, sec. 1131 of the Reform Act, and sec. 4972 of the Code)

Present Law

In general

Under present law, a 10-percent nondeductible excise tax is imposed on nondeductible contributions to a qualified plan (secs. 401(a) and 403(a)) or simplified employee pension (SEP) (sec. 408(k)).

Amount of nondeductible contributions

The contributions to a plan that are subject to the excise tax on nondeductible contributions are (1) the amounts contributed to a qualified employer plan by the employer for the taxable year in excess of the amount allowable as a deduction for the taxable year, plus (2) the unapplied amounts in the preceding taxable year. The unapplied amounts in the preceding taxable year are the amounts subject to the excise tax in the preceding year reduced by the sum of (1) the portion of the amounts that are returned to the employer during the taxable year, and (2) the portion of such unapplied amounts that are deductible during the current taxable year.

Time for determination of nondeductible contributions

Nondeductible contributions for a year are determined as of the close of the employer's taxable year. A contribution made on account of a year that is made after the close of the year is to be taken into account in determining the level of excess contributions for the year with respect to which the contribution is made.

Nondeductible contributions to underfunded plans

Under the Act, the excise tax on nondeductible contributions applies to nondeductible contributions to underfunded plans.

Definition of employer

The excise tax on nondeductible contributions is imposed on the employer. Under present law, in the case of a plan that provides contributions or benefits for employees some or all of whom are self-employed individuals (sec. 401(c)(1)), an individual who owns the entire interest in an unincorporated trade or business is treated as the employer. Also, under present law, a partnership is to be treated as the employer of each partner who is considered to be an employee (sec. 401(c)(1)).

Under the Act, an employer to whom the excise tax on nondeductible contributions applies includes an employer that is a tax-exempt organization.

Explanation of Provision

Amount of nondeductible contributions

Under the bill, the definition of nondeductible contributions includes, for purposes of the excise tax, contributions allocable to the purchase of life, accident, health, or other insurance on behalf of a self-employed individual, but only to the extent that the contributions would be nondeductible without regard to the special rule limiting deductions for such contributions (sec. 404(e)).

The bill clarifies that the amount allowable as a deduction (without regard to sec. 404(e)) for any taxable year is treated as coming first from carryforwards to the taxable year from preceding taxable years (in order of time) and then from employer contributions made during the taxable year.

Further, under the bill, the unapplied amounts in the preceding taxable year do not include nondeductible contributions made for years prior to the effective date of the excise tax on nondeductible contributions. However, in determining whether contributions after the effective date are subject to the excise tax, carryforwards from pre-effective date years are applied first against the deduction limit (without regard to sec. 404(e)).

Time for determination of nondeductible contributions

Because the determination of nondeductible contributions as of the end of a taxable year includes contributions made after the close of the taxable year with respect to the year, the bill provides that contributions that are returned (together with the income allocable thereto) to an employer (to the extent permitted under sec. 401(a)(2)) by the due date of plan contributions for the year (sec. 404(a)(6)) are not treated as nondeductible contributions subject to the excise tax.

Nondeductible contributions to underfunded plans

Under the bill, the excise tax on nondeductible contributions does not apply in the case of a plan that is underfunded and to which Title IV of ERISA applies. A plan is underfunded if, as of the close of the plan year with or within which the taxable year begins, (1) the liabilities of the plan (determined as if the plan were terminated on that date) exceed (2) the assets of the plan. In the case of such an underfunded plan, contributions for a plan year up to the excess calculated under the preceding sentence are not subject to the excise tax even if such contributions are not deductible by the employer.

Definition of employer

The bill provides that the excise tax on nondeductible contributions does not apply in the case of an employer that has been exempt from income tax at all times. Under rules to be prescribed by the Secretary, this exception does not apply to the extent that the employer has been subject to unrelated business income tax or has otherwise derived a tax benefit from the qualified plan.

The original rationale for the excise tax was that, by making nondeductible contributions to qualified plans, often the benefit of tax-free growth on the amounts contributed outweighed the delay in the employer's deduction for plan contributions. Such an incentive to make nondeductible contributions increased the likelihood that employers would use qualified plans as a tax-favored savings vehicle, particularly in the case of small plans that primarily benefit the owners of the employer. The excise tax on reversions may not offset the value of the deferral of tax on earnings on nondeductible contributions to qualified plans.

Such a rationale does not apply in the case of contributions to plans maintained by governments or tax-exempt organizations. In the case of such plans, the employer generally has no incentive to make plan contributions solely to receive the benefit of tax-free growth because the employer could hold the funds directly without incurring current income tax. Thus, an incentive to use a qualified plan as a tax-favored savings vehicle generally does not exist in the case of a qualified plan maintained by a government or tax-exempt employer.

Effective Date

The bill provides a delayed effective date for the changes in the deduction rules for plans maintained pursuant to a collective bargaining agreement (see the discussion in Part E, below).

3. Excise tax on reversion of qualified plan assets to employer (sec. 111A(f) of the bill, sec. 1132 of the Reform Act, and sec. 4980 of the Code)

Present Law

In general

Under present law, a 10-percent excise tax is imposed on a reversion from a qualified plan. The excise tax is imposed on the employer maintaining the plan.

Present law defines a reversion as the amount of cash and the fair market value of other property received (directly or indirectly) by an employer from a qualified plan. No inference is to be drawn from the definition of a reversion as to the income tax consequences and the effect on a plan's qualified status of a transfer of assets from a qualified plan that has not been terminated to another qualified plan.

Special rule for assets transferred to ESOPs

Present law provides an exception to the excise tax on reversions in the case of transfers of assets from a defined benefit pension plan to an employee stock ownership plan (ESOP). The amount transferred is not includible in the income of the employer, nor is the amount transferred deductible by the employer as a plan contribution. No inference is to be drawn from this exception as to the circumstances in which asset transfers will or will not satisfy the exclusive benefit rule and any other applicable qualification requirements (e.g., sec. 414(l)).

Under present law, the amount transferred to the ESOP is required to be used, within 90 days after the transfer, to acquire employer securities (as defined in sec. 409(l)) or used to repay a loan the proceeds of which are or were used to acquire employer securities.

The employer securities acquired with the amounts transferred are to be allocated immediately under the plan to ESOP participants, subject to the limits under section 415. As provided under the plan, the amount transferred but not allocated in the year of transfer (by reasons of the limitation of sec. 415) may be held in a suspense account pending allocation (provided allocations of the amounts in the suspense account are made no more slowly than ratably over a 7-year period).

The employer securities acquired with the transferred assets are to be held under the plan until distributed to plan participants.

The special exception for transfers to an ESOP does not apply to transfers occurring on or after January 1, 1989, unless the transfer occurs on account of a plan termination before January 1, 1989.

Explanation of Provision

The bill clarifies that the exception to the excise tax on reversions in the case of transfers of assets to an ESOP applies to transfers to tax-credit ESOPs (sec. 409) as well as ESOPs described in section 4975(e)(7). Absent this clarification, a tax-credit ESOP would be required, in order to qualify for the ESOP exception, to add plan langauage applicable to leveraged ESOPs even if the ESOP did not have any outstanding loans.

The bill provides an exception to the rule that the employer securities acquired with transferred assets are to be held under the plan until distributed to plan participants. Under this exception, the transferred amounts are not required to be held in employer securities if a plan participant elects to diversify a portion of the participant's account balance (under the rules of sec. 401(a)(28)) and diversification cannot be satisfied out of nontransferred assets.

In addition, the bill provides that, with respect to the allocation of employer securities, the miminim amount required to be allocated to participants' accounts in the ESOP in the year in which the transfer occurs is not to be less than the lesser of (1) the maximum amount that could be allocated without violating the requirements of section 415, or (2) ⅛ of the total amount transferred. Thus, the requirement in the Reform Act that amounts transferred to an ESOP are required to be allocated in the year of transfer up to the maximum amount permitted to be allocated under the limits on contributions (sec. 415) is repealed.

Finally, the bill clarifies the exception for transfers to ESOPs to the general rule that the employer is required to include the amount of any reversion in income. Under the bill, the exception to the income inclusion requirement applies to any reversion occurring after March 31, 1985, if the reversion is transferred to an ESOP, subject to the general Januay 1, 1989, termination of the ESOP exception.

4. Excise tax on excess distributions from qualified retirement plans (sec. 111A(g) of the bill, sec. 1133 of the Reform Act, and sec. 4981A of the Code)

Under the Act, an excise tax is imposed on excess distributions from qualified retirement plans, tax-sheltered annuities, and IRAs. To the extent that aggregate annual distributions paid to a participant from such tax-favored retirement arrangements are excess distributions, the Act generally imposes an excise tax equal to 15 percent of the excess. The excise tax will be reduced by the amount of tax on the distribution under the provision applying a 10-percent additional income tax on early withdrawals.

a. Definition of excess distributions

Present Law

Under the Act, excess distributions are defined as the aggregate amount of retirement distributions made with respect to any individual during any calendar year, to the extent such amounts exceed $112,500 (adjusted at the same time and in the same manner as the dollar limitation on annual benefits under a defined benefit pension plan).

The Act provided a special elective grandfather rule with respect to benefits accrued as of August 1, 1986. If this grandfather rule is not elected, then the definition of excess distributions is the greater of (1) $112,500 (adjusted at the same time and in the same manner as the dollar limitation on annual benefits under a defined benefit pension plan) or (2) $150,000.

Explanation of Provision

The operation of the grandfather provision of the Act in effect overrode the general definition of excess distributions in the Act. Thus, the general definition of excess distributions is the agggregate amount of retirement distributions made with respect to any individual during any calendar year, to the extent such amounts exceed the greater of (1) $112,500 (adjusted at the same time and in the same manner as the dollar limitation on annual benefits under a defined benefit pension plan), or (2) $150,000. The bill restructures the provision to make the general rule clear.

b. Distributions subject to the tax

Present Law

In determining the amount of retirement distributions that are subject to the excise tax, aggregate annual distributions made with respect to an individual from all pension, profit-sharing, stock bonus, and annuity plans, IRAs, and tax-sheltered annuities generally are taken into account, regardless of the form of the distribution or the number of recipients.

Under the Act, however, certain amounts are excluded in determining such aggregate annual distributions. Excludable distributions include (1) amounts representing a return of an employee's after-tax contributions (but not earning thereon) or other amounts that are treated as part of the employee's investment in the contract, (2) amounts excluded from the recipient's income because they are rolled over into another plan or an IRA, and (3) amounts excluded from the participant's income because they are payable to a former spouse pursuant to a qualified domestic relations order (sec. 414(p)) and includible in the spouse's income.

Explanation of Provision

The bill clarifies that the exception to the amounts taken into account in determining aggregate annual distributions under a plan for investment in the contract is not limited to an employee's investment in the contract under a qualified plan, but also includes an individual's investment in the contract under an IRA. The Act was not intended to limit the exception for investment in the contract to amounts received by employees in their capacity as such.

In addition, the bill provides that, in the case of an annuty contract that is distributed to an individual and not included in the individual's income when the contract is distributed, the distribution of the contract is disregarded in applying this excise tax. Rather, payments made under or received for such an annuity contract are treated as retirement distributions subject to the excise tax to the extent they are excess distributions.

In order to identify only those qualified plan distributions that represent a payment of a benefit under the plan, the bill provides that certain amounts returned to an employee under a qualified cash or deferred arrangement or a plan subject to the special nondiscrimination requirements for employee contributions and employer matching contributions are not treated as part of the aggregate annual distributions under a plan. Thus, under the bill, aggregate annual distributions do not include a distribution, with respect to an individual, of excess deferrals (as defined in sec. 402(g)), excess contributions (as defined in sec. 401(k)(8)), excess aggregate contributions (as defined in sec. 401(m)(6)), or certain amounts withdrawn from an IRA before the due date of the return (sec. 408(d)(4)).

Under the bill, the operation of community property laws is disregarded in determining the amount of aggregate annual distributions subject to the excise tax. Thus, just as a nonemployee spouse's interest in an employee spouse's pension benefit is not taken into account in determining the taxable income of an employee upon distribution from or under a qualified plan, a nonemployee spouse's interest in such distributions is also disregarded in determining aggregate annual retirement distributions subject to the excise tax.

c. Grandfather rule

Present Law

Under the Act, certain individuals may elect to be covered by a special grandfather rule that exempts from the excise tax benefits accrued as of August 1, 1986 (including benefits accrued under any arrangements distributions from which are subject to the tax). Under the grandfather, in the case of a defined contribution plan or IRA, the accrued benefit of a participant as of August 1, 1986, is the participant's accrued benefit on that date. In the case of a defined benefit pension plan, the accrued benefit as of August 1, 1986, is the present value of the participant's benefit under the plan, determined as if the participant separated from service on that date. Benefits accrued as of August 1, 1986, to which the participant does not have a nonforfeitable right are included in the definition of accrued benefits for purposes of the grandfather rule.

If the grandfather rule is elected, then, for all purposes, the threshold for retirement distributions that are excess distributions is $112,500 (indexed), rather than the greater of $112,500 (indexed) or $150,000.

The election to use the grandfather rule is to be made on a return for a year beginning no later than January 1, 1988, and is to be made in such form and contain such information as the Secretary may prescribe. The election, once made, applies generally to all retirement distributions made with respect to an individual, including amounts subject to the special estate-level tax after the individual's death. In addition, if an individual dies before the end of the election period, the executor of the individual's estate may make the grandfather election.

The grandfather rule may only be elected with respect to an individual if, as of August 1, 1986, the present value of the individual's interests subject to the excess distribution tax (if such tax were in effect on that date) exceeds $562,500.

Explanation of Provision

Under the bill, for purposes of the grandfather rule, benefits accrued as of August 1, 1986, do not include amounts that, as of August 1, 1986, would not be distributions subject to the excise tax if distributed on that date. Thus, under the bill, an individual's accrued benefit, for purposes of the grandfather, does not include any portion of the accrued benefit that, as of August 1, 1986, (1) is payable to an alternate payee pursuant to a qualified domestic relations order (sec. 414(p)) if includible in the income of the alternate payee, or (2) is attributable to the individual's investment in the contract.

In addition, the bill clarifies that the grandfather rule is available if amounts are received with respect to an individual under (1) the general rule, (2) the special rule for lump-sum distributions, or (3) the special estate tax.

d. Post-death distributions

Present Law

The Act provided special rules to calculate the extent to which retirement distributions made with respect to an individual after the individual's death are excess distributions subject to the excise tax. In lieu of subjecting the post-death distributions (including distributions of death benefits) to the annual tax on excess distributions, the Act added an additional estate tax equal to 15 percent of the individual's excess retirement accumulation. After the estate tax is imposed, post-death distributions are disregarded entirely in applying the excise tax on excess distributions. Thus, beneficiaries who are receiving distributions (other than certain former spouses receiving benefits pursuant to a qualified domestic relations order) are not required to aggregate those amounts with any other retirement distributions received on their behalf.

The excess retirement accumulation is defined as the excess (if any) of the value of the decedent's interests in all qualified retirement plans, annuity plans, tax-sheltered annuities, and IRAs, over the present value of annual payments equal to the annual excess distribution ceiling for a period equal to the life expectancy of the individual immediately before death.

In calculating the amount of the excess retirement accumulation, the value of the decedent's interest in all qualified plans, tax-sheltered annuities, and IRAs will be taken into account regardless of the number of beneficiaries.

Explanation of Provision

The bill clarifies that, as is the case under the general rule, the amount of the excess retirement accumulation with respect to an individual for purposes of the special estate tax is determined without regard to community property laws. This rule is provided so that the treatment of post-death distributions is consistent with the treatment of distributions made with respect to an individual prior to death.

In addition, under the bill, benefits that represent the decedent's investment in the contract or amounts payable to an alternate payee and includible in the alternate payee's income are disregarded in determining the excess retirement accumulation.

The bill redefines the excess retirement accumulation to be the excess (if any) of the present value of the decedent's interests in all qualified retirement plans, annuity plans, tax-sheltered annuities, and IRAs, over the present value (as determined under rules prescribed by the Secretary as of the applicable valuation date) of a single life annuity with annual payments equal to the annual excess distribution limit (as in effect for the year in which death occurs and as if the individual had not died).

Under the bill, the amount of excess retirement accumulations with respect to an individual does not include amounts that are death benefits payable with respect to such individual. Therefore, the bill provides that the amount of excess retirement accumulations does not include the value of any death benefits payable by the plan immediately after death with respect to a decedent to the extent that the sum of such death benefits plus other benefits payable with respect to the decedent exceeds the total value of benefits payable with respect to the decedent immediately prior to death.

The bill clarifies that, with respect to this special estate-level tax, the tax may not be offset by any credits against the estate tax (such as the unified credit).

Further, the bill provides an exception to the general rule that the special estate-level tax applies to all excess retirement accumulations with respect to an individual and that, after the estate-level tax is imposed, a beneficiary receiving distributions with respect to the individual is not required to aggregate the amounts received with any other retirement distributions received by the beneficiary on the beneficiary's own behalf. Under this exception, if the spouse of an individual is the beneficiary of all retirement accumulations with respect to the individual, the spouse may elect, on a form attached to the estate tax return, (1) not to have the special estate-level tax apply and (2) for purposes of the general rule, to have the distributions received with respect to the individual aggregated with any distributions that the spouse receives on the spouse's own behalf. Thus, the amounts received with respect to the individual would be subject to the general excise tax on excess distributions to the extent that the amounts, when aggregated with the spouse's own benefits from or under qualified plans, tax-sheltered annuities, and IRAs, exceed the threshold for the excise tax.

For purposes of this exception to the estate-level tax, if 1 or more persons other than the spouse are beneficiaries of a de minimis portion of the interests with respect to the individual that otherwise would be subject to the estate-level tax, then the spouse is not treated as failing to receive all excess retirement accumulations with respect to the individual. Further, such de minimis amounts are not subject to the excise tax on excess distributions nor to the special estate-level tax if the spouse makes the election described above. For purposes of this rule, an amount will not be considered de minimis if it exceeds 1 percent of the decedent's retirement accumulation.

e. Effective date

Present Law

Under the Act, the provisions generally apply to distributions made after December 31, 1986. The special estate-level tax applies with respect to the estate of a decedent dying after December 31, 1986.

Explanation of Provision

The bill clarifies that the provisions do not apply to distributions with respect to a decedent who dies before January 1, 1987.

E. Miscellaneous Pension and Deferred Compensation Provisions

1. Discretionary contribution plans (sec. 111A(j) of the bill, sec. 1136 of the Reform Act, and secs. 401(a) (27), 404, and 818 of the Code)

Present Law

Under present law, employer contributions to a profit-sharing plan are not limited to the employer's current or accumulated profits. Contributions to a money purchase pension plan are required to be fixed without reference to profits.

Explanation of Provision

Under the bill, a trust forming part of a plan will not be qualified unless the plan designates (at such time and in such manner as the Secretary may prescribe) whether the plan is intended to be a money purchase pension plan or a profit-sharing plan. Of course, a plan amendment is not required to comply with this rule until such time as plan amendments generally are required under the Act (sec. 1140).

2. Time required for plan amendments (sec. 111A(l) of the bill and sec. 1140 of the Reform Act)

Present Law

The Act generally allowed plans that operated in compliance with the new requirements of Title XI of the Act to delay the corresponding plan amendments to a specified time.

Explanation of Provision

The bill provides the same delayed amendment rules with respect to the plan amendments required by Title XVIII of the Act (the technical corrections title) or by the bill itself. This furthers the intent of Congress to ease the administrative burdens on plans by delaying the date required for certain amendments so that, in general, all required amendments can be made in a single year.

In addition, the bill provides that a collective bargaining agreement is not to be treated as terminated merely because a plan is amended pursuant to the agreement to meet the requirements of Title XI or Title XVIII of the Act. The bill does not intend to create an inference that such an amendment otherwise would be considered a termination, or that an amendment made solely to conform a plan to a requirement added by another Act is considered a termination.

3. Federal Thrift Savings Plan (sec. 111A(n) of the bill, sec. 1147 of the Reform Act, and secs. 3121(v) and 7701(j) of the Code)

Present Law

Beginning in 1987, an employee generally is permitted to contribute up to 10 percent of the employee's rate of basic pay to the Thrift Savings Plan maintained by the Federal Government. If special nondiscrimination requirements are satisfied and the limitation on elective deferrals is not exceeded, contributions to the plan are not treated as made available merely because the employee had an election to receive the amounts in cash. Therefore, the amounts deferred are not includible in an employee's income until distributed.

Explanation of Provision

The bill clarifies that the Thrift Savings Plan is required to meet the rules of section 401(k)(4)(B) under which the Plan may not be maintained by any State or local government or any tax-exempt organization.

In addition, under the bill, the Thrift Savings Fund may elect to have the nondiscrimination requirements applied separately to contributions to the Fund with respect to employees who are covered by the Civil Service Retirement and Disability System (CSRS) and thus are treated differently under the Thrift Savings Plan (e.g., with respect to matching contributions). Separate treatment under the nondiscrimination rules is analogous to the rules applicable to qualified plans maintained by employers other than the Federal Government.

4. Effective dates for collectively bargained plans (secs. 111(c), (g), (h), and (n), and 111A(e) of the bill, and secs. 1105, 1111, 1112, 1120, and 1131 of the Reform Act)

Present Law

Under the Act, the effective dates of certain provisions are delayed with respect to plans maintained pursuant to 1 or more collective bargaining agreements between employee representatives and 1 or more employers ratified before March 1, 1986 ("collectively bargained plans"). In some cases, the delayed effective date applies to the entire plan and, in other cases, the delay only applies to, for example, individuals covered by 1 or more of the collective bargaining agreements.

The provisions subject to the delayed effective date generally do not apply to years beginning before the earlier of—

(1) the later of (a) January 1, 1989 (or, in certain cases, January 1, 1987) or (b) the date on which the last of the collective bargaining agreements terminates (determined without regard to any extension thereof after February 28, 1986), or

(2) January 1, 1991 (or, in certain cases, January 1, 1989).

Explanation of Provision

The bill generally provides that the delayed effective date with respect to collectively bargained plans applies to the entire plan in the case of the amendments made by section 1111 (relating to the application of nondiscrimination rules to integrated plans) and 1112 (relating to the minimum coverage and participation requirements for qualified plans) of the Act. As under present law, this delayed effective date does not apply to any noncollectively bargained plans even if such plans have terms identical to those of a collectively bargained plan.

Also, the bill modifies the delayed effective date with respect to the amendments made by section 1105, relating to the $7,000 limit on elective deferrals. Under present law, the $7,000 limit does not apply to contributions under a collectively bargained plan made pursuant to 1 or more of the collective bargaining agreements relating to the plan for taxable years beginning before the earlier of—

(1) The date on which the last of such collective bargaining agreements terminates (determined without regard to any extension thereof after February 28, 1986), or

(2) January 1, 1991.

Under the bill, clause "(1)" above is modified to refer to the date on which the collective bargaining agreement pursuant to which the contribution is being made terminates. This change is appropriate because the $7,000 limit is applied at the individual taxpayer level. Thus, the later termination of a collective bargaining agreement to which an individual is not subject should not affect that individual's tax treatment.

The bill also provides a delayed effective date for collectively bargained plans with respect to 2 additional sections of the Act. First, the amendments made by section 1120, applying nondiscrimination rules to tax-sheltered annuity programs (sec. 403(b)), are not to apply to collectively bargained plans in plan years beginning before the earlier of—

(1) the later of (a) January 1, 1989, or (b) the date on which the last of the collective bargaining agreements terminates (without regard to any extension thereof after February 28, 1986), or

(2) January 1, 1991.

This delayed effective date applies to the entire program.

In addition, the amendments made by section 1131, relating to the limits on deductions for contributions under a qualified plan and to the excise tax on nondeductible contributions under a qualified plan, are not to apply to contributions under a collectively bargained plan made pursuant to any of the collective bargaining agreements relating to the plan for taxable years beginning before the earlier of—

(1) January 1, 1989, or

(2) the date on which the last of the collective bargaining agreements terminates (determined without regard to any extension thereof after February 28, 1986).

F. Employee Benefit Provisions

1. Nondiscrimination rules for statutory employee benefit plans (sec. 111B(a) of the bill, sec. 1151 of the Reform Act, sec. 209 of the Social Security Act, and secs. 89, 125, 129, 414, 3121, 3231, 3306, 3401, and 6652 of the Code)

In general

Under present law, new nondiscrimination rules apply to statutory employee benefit plans (sec. 89). The term "statutory employee benefit plans" includes accident or health plans and group-term life insurance plans. At the election of the employer, the term also includes qualified group legal services plans, educational assistance programs, and dependent care assistance programs.

Under the new nondiscrimination rules, a plan generally is required to satisfy 3 eligibility tests—a 50-percent test, a 90-percent/50-percent test, and a nondiscriminatory provision test—and a benefits test. Alternatively, a plan may satisfy an 80-percent coverage test, provided it also satisfies the nondiscriminatory provision test.

Nondiscrimination tests

50-percent test

Under the 50-percent test, nonhighly compensated employees must constitute at least 50 percent of the group of employees eligible to participate in the plan. This requirement will be deemed satisfied if the percentage of highly compensated employees who are eligible to participate is not greater than the percentage of nonhighly compensated employees who are eligible.

90-percent/50-percent test

A plan does not satisfy the 90-percent/50-percent test unless at least 90 percent of the employer's nonhighly compensated employees are eligible for a benefit that is at least 50 percent as valuable as the benefit available to the highly compensated employee to whom the most valuable benefit is available. For purposes of this test, all plans of the same type (i.e., all benefits excludable under the same Code section) are aggregated.

For purposes of this 90-percent/50-percent test, available salary reduction is not taken into account.

Nondiscriminatory provision test

The third eligibility test provides that a plan may not contain any provision relating to eligibility to participate that by its terms or otherwise discriminates in favor of highly compensated employees. This third test is intended to disqualify arrangements only on the basis of discrimination that is not quantifiable.

Benefits test

A plan does not satisfy the benefits test unless the average employer-provided benefit received by nonhighly compensated employees under all plans of the employer of the same type (i.e., plans providing benefits excludable under the same Code section) is at least 75 percent of the average employer-provided benefit received by highly compensated employees under all plans of the employer of the same type.

Alternative test

Present law also provides an alternative test that may be applied in lieu of the eligibility and benefits tests described above. If a plan benefits at least 80 percent of an employer's nonhighly compensated employees, such plan is considered to satisfy the new nondiscrimination rules. This alternative test will not apply unless the plan satisfies the nondiscriminatory provision test described above.

This alternative test applies only to accident or health plans and group-term life insurance plans. For purposes of this alternative test, an individual will only be considered to benefit under a plan if such individual receives coverage under the plan; eligibility to receive coverage is not considered benefiting under the plan.

Valuation

The Secretary is to prescribe rules regarding valuation of different benefits. With respect to health coverage, the Secretary is to prescribe tables prescribing the relative values of different types of health coverage.

Definitions

For purposes of applying the new nondiscrimination rules, present law provides generally applicable definitions of the following: (1) highly compensated employee (sec. 414(q)); (2) employer (including the employee leasing rules (sec. 414 (b), (c), (m), (n), (o), and (t))); (3) line of business or operating unit (as present law permits the new nondiscrimination rules to be applied separately to separate lines of business or operating units (sec. 414(r))); and (4) employees who are excluded from consideration. These definitions, other than the line of business or operating unit rule, apply generally to all employee benefit plans, not only to statutory employee benefit plans.

Qualification and reporting requirements

Employee benefit plans generally are subject to new qualification and reporting requirements (sec. 89(k) and (l)).

a. Employers with no nonhighly compensated employees

Present Law

Under present law, the nondiscrimination rules applicable to statutory employee benefit plans are applied by reference to the eligibility of nonhighly compensated employees to participate in a plan or to the amount of benefits provided to nonhighly compensated employees under a plan. It is unclear under present law how these nondiscrimination rules apply in the case of an employer who has no nonhighly compensated employees.

Explanation of Provision

The bill clarifies that the nondiscrimination rules do not apply to an employer in a year in which such employer has no nonhighly compensated employees. As is so with respect to the nondiscrimination rules generally, this rule is to apply separately with respect to former employees under rules prescribed by the Secretary.

b. Plan aggregation

Present Law

Under present law, each different option generally is a separate plan for testing purposes. However, for purposes of the 50-percent eligibility test and the 80-percent alternative test, comparable accident or health plans may be aggregated (sec. 89(g)(1)).

Explanation of Provision

The bill provides that, under rules prescribed by the Secretary, if an employee is eligible for (in the case of the 50-percent test) or receives coverage under more than 1 accident or health plan, then, for purposes of the 50-percent test and the alternative 80-percent test, such plans are required to be considered 1 plan with respect to such employee.

For example, assume that an employer maintains 2 plans: 1 benefiting all employees with a value of $950 and a second benefiting only highly compensated employees with a value of $1,000. The highly compensated employees receiving benefits from both plans are to be treated for purposes of the 50-percent test and the alternative 80-percent test as receiving $1,950 of benefits from 1 plan while the nonhighly compensated employees are to be treated as receiving $950 of benefits from a separate plan. Under the comparability rules (sec. 89(g)(1)), these plans would not be comparable so that the plan covering the highly compensated employees would satisfy neither the 50-percent test nor the alternative 80-percent test.

c. Family coverage

Present Law

Under present law, a special rule applies in the case of family coverage under an accident or health plan. Pursuant to this special rule, the coverage for employees and the coverage for spouses and dependents may be tested separately, as if they constituted 2 different types of plans, for purposes of the 90-percent/50-percent test. Further, for purposes of the same test, with respect to coverage of spouses and dependents, the employer may disregard employees who do not have a spouse or dependent. An employer who elects this latter optional rule is required to obtain and maintain, in such manner as the Secretary prescribes, adequate sworn statements to demonstrate whether employees have a spouse or dependent.

Explanation of Provision

The bill deletes the rule allowing employers to apply the 90-percent/50-percent test separately with respect to family coverage and to take into account for such purpose only employees who have a family. This rule implies that family coverage cannot be considered available to an employee who does not have a family.

Under the bill, family coverage (i.e., coverage of an employee's family which is considered separate from coverage of the employee) may be considered to be available or provided to an employee despite the fact that the employee does not have a family. The purpose of this rule is to relieve employers from the burden of determining which employees have families.

This rule alone, however, could produce inappropriate results in certain very limited circumstances and it is intended that the nondiscriminatory provision test be applied to prevent such results. Thus, if, under the facts and circumstances, it is clear that the employer is, by using the above rule that allows family coverage to be considered to be available or provided to an employee who does not have a family, evading the other nondiscrimination tests, the nondiscriminatory provision test is not to be considered satisfied with respect to the relevant plan or plans.

For example, assume that an employer had 2 highly compensated employees and 8 nonhighly compensated employees, none of whom had families. The employer provided $3,000 of employee coverage to each of the 2 highly compensated employees. For the same year, the employer provided family coverage to each of the 8 nonhighly compensated employees the value of which was $3,000 per employee under the Secretary's valuation tables. Because comparable plans may be aggregated for purposes of the alternative 80-percent test, the employer would satisfy such test. This is not the result intended by Congress, since the facts of this example clearly indicate that by using the rule allowing family coverage to be considered to be provided to employees without families, the employer is avoiding providing the nonhighly compensated employees truly nondiscriminatory benefits. Thus, the nondiscriminatory provision test would not be considered satisfied with respect to the plan covering the highly compensated employees.

This application of the nondiscriminatory provision test applies not only with respect to evasion of the alternative 80-percent test, but to evasion of any of the tests. For example, the nondiscriminatory provision test would not be considered satisfied with respect to a plan maintained by the employer in the above example for its highly compensated employees if such plan satisfied the 90-percent/50-percent test by virtue of a second plan making family coverage available to the nonhighly compensated employees.

d. Sworn statements

Present Law

For purposes of applying the benefits test to accident or health plans, an employer generally (see sec. 89(g)(2)(D)) may elect to disregard any employee or family member of an employee if such individual is covered by a health plan that provides core benefits and that is maintained by another employer of the employee or of a member of the employee's family. An employer who elects this optional rule is required to obtain and maintain, in such manner as the Secretary prescribes, adequate sworn statements to demonstrate whether individuals have core health coverage from another employer.

Explanation of Provision

The bill provides that, with respect to an employer ("first employer"), an individual may be considered to have core health benefits from another employer of such individual or of a member of such individual's family, despite the fact that no sworn statement is obtained and maintained to that effect, if (1) the first employer makes available to an employee, at no cost, core health benefits with respect to such individual, and (2) no health benefits under any plan of the first employer are provided with respect to such individual. For purposes of this rule, any financial detriment with respect to core health benefits, regardless of whether it is direct or indirect, current or future, fixed or contingent, is considered a cost rendering this special rule inapplicable. A benefit that is available to an employee on the condition that such employee reduce his salary or forego another benefit is considered available at a cost.

Under present law, with respect to an employer that elects to disregard individuals covered (or deemed covered under the rule described above) by another employer's core health benefits, in the absence of a sworn statement, a highly compensated employee is treated as (1) covered by a plan of another employer providing core health benefits, and (2) not having a spouse or dependent. Thus, the special rule under the bill described above only affects non-highly compensated employees.

e. Excluded employees

Present Law

Under present law, certain classes of employees are disregarded in applying the nondiscrimination rules if neither the plan, nor any other plan of the same type, is available to any employee in the same class. Two of the disregarded classes are (1) in the case of an accident or health plan (other than with respect to noncore benefits), employees who have not completed 6 months of service (or such shorter period of service as may be specified in the plan); and (2) in the case of any other statutory employee benefit plan (including an accident or health plan with respect to noncore benefits), employees who have not completed 1 year of service (or such shorter period of service as may be specified in the plan).

An employer is to exclude an employee, on the grounds that such employee has not satisfied the required period of initial service, during the period prior to the first day of the calendar month immediately following the actual satisfaction of the initial service requirement. In general, this exclusion does not apply if any employee is eligible under any plan of the same type prior to the first day of the calendar month immediately following the actual satisfaction of the initial service requirement.

In addition, the legislative history of the Act provided certain rules of convenience, relating to the time at which the nondiscrimination rules are to be applied, that were intended to reduce the administrative burden of applying the nondiscrimination rules.

Explanation of Provision

Under the bill, the rule regarding the exclusion of employees between the date of actual satisfaction of the initial service requirement and the first day of the calendar month immediately following such satisfaction is modified so that an employer may use, instead of the first day of the next calendar month, the first day of a period of less than 31 days specified by the plan. For example, assume that an employer required 60 days of service for participation in a health plan, but did not allow participation to commence other than on the first day of 4-week periods. Such employer is to exclude employees during the period prior to the first day of the 4-week period following satisfaction of the 60-days-of-service requirement.

The Secretary is to provide corresponding changes to the rules of convenience relating to the time for testing described in the legislative history of the Act.

This amendment, allowing use of a period of less than 31 days, provides employers with flexibility without adversely affecting the policy of the nondiscrimination rules.

f. Self-employed individuals

Present Law

Under the Act, it is unclear whether self-employed individuals are treated as employees for purposes of the nondiscrimination rules applicable to statutory employee benefit plans.

Explanation of Provision

The bill clarifies that, for purposes of applying the nondiscrimination rules to statutory employee benefit plans, the term "employee" includes any self-employed individual (as defined in sec. 401(c)(1)), and the term "compensation" includes such individual's earned income (as defined in sec. 401(c)(2)).

In addition, an individual who owns the entire interest in an unincorporated trade or business is to be treated as his own employer. A partnership is to be treated as the employer of each partner who is treated as an employee under the rule described above.

These rules do not affect whether a self-employed individual may exclude a benefit provided under a statutory employee benefit plan. For example, group-term life insurance provided to a self-employed individual may not be excluded by the self-employed individual because section 79 does not apply to self-employed individuals. The effect of this provision of the bill is to count a self-employed individual as an employee even though such individual is not eligible for the exclusion. Generally, this will facilitate compliance with the nondiscrimination rules, since self-employed individuals, who generally are highly compensated employees under the applicable definition (sec. 414(q)), are taken into account but treated only as eligible for and receiving benefits that are excludable or deductible. Thus, for example, with respect to health benefits, a self-employed individual is treated as receiving (or eligible for) a benefit equal to 25 percent of the amount paid (or payable) for health insurance, since that is the only amount that is tax-favored with respect to a self-employed individual (secs. 106 and 162(m)).

g. Sanctions

Present Law

Year of inclusion

Under present law, if a plan is discriminatory in a plan year, highly compensated employees are taxable on the value of the discriminatory excess in their taxable year in which or with which the plan year ends.

Discriminatory excess

The discriminatory excess is defined as the amount of the otherwise nontaxable employer-provided benefit (including benefits purchased with elective contributions) that would have to have been purchased with after-tax employee contributions by the highly compensated employees in order for all of the nondiscrimination tests to be satisfied. In the case of group-term life insurance, the value of discriminatory coverage is the greater of the cost of coverage under section 79(c) or the actual cost of coverage.

Employer sanction

If the employer does not report the discriminatory excess (or other amounts includible under sec. 89) in a timely manner, the employer may be subject to an employer-level sanction (sec. 6652(l)).

Explanation of Provision

Year of inclusion

Under present law, if a plan is discriminatory and the plan year is, for example, the calendar year, the employer has only 1 month to determine the discriminatory excess with respect to the highly compensated employees in order to file accurate Forms W-2 in a timely manner. In many cases, this is not a sufficient period of time. Thus, the bill provides a special rule with respect to plans with a plan year ending after September 30 and on or before December 31 of a calendar year.

Under this special rule, an employer may elect to have the discriminatory excess included in the incomes of highly compensated employees in their taxable year following the taxable year with or within which the plan year ends. If an employer makes such an election, however, the employer's deduction relating to such discriminatory excess is to be allowable only in the employer's taxable year with or within which ends the plan year following the plan year in which the discriminatory excess occurred. It is not intended, however, that an employer be permitted to avoid the deferral of the deduction through the use of a short plan year following the plan year in which the discriminatory excess occurred.

Discriminatory excess

For purposes of determining and allocating the discriminatory excess with respect to a group-term life insurance plan, employer-provided coverage over $50,000 will be treated as nontaxable under the bill. Thus, to the extent that the discriminatory coverage does not exceed the total coverage over $50,000, the effect of a finding of discrimination is simply the inclusion in income of the excess, if any, of the actual cost of the discriminatory coverage over the cost of such coverage under section 79(c).

For example, assume an employee receives $150,000 of employer-provided coverage and the $100,000 excess over $50,000 is included in income, at the cost determined under section 79(c), pursuant to section 79(a). Assume further that $25,000 of such employee's coverage is determined to be discriminatory. The effect of this finding of discrimination is that the excess, if any, of the actual cost of such $25,000 of coverage over the section 79(c) cost of such coverage is included in the employee's income (in addition to the section 79(c) cost of the $100,000 of coverage (i.e., the amount over $50,000)).

Qualification rule

If a plan to which section 505 applies—generally, a plan part of which is a voluntary employees' beneficiary association (VEBA) (sec. 501(c)(9)) or a qualified group legal services organizations (GLSO) (sec. 501(c)(20))—violates the new qualification requirements (sec. 89(k)), the VEBA or GLSO is not to be exempt from tax under section 501(a). A plan failing to satisfy the new qualification requirements is not the type of plan for which the VEBA or GLSO tax exemption was established.

Employer sanction

If an employer does not report a discriminatory excess (or other amount includible under sec. 89) in a timely manner, the employer may be subject to an employer-level sanction. Under the bill, it is clarified that the employer-provided benefit subject to the employer sanction is determined under the general rules applicable under section 89 except that the special rule relating to group-term life insurance plans, under which employees are assumed to be age 40, does not apply. Of course, the adjustment of the employer-provided benefit under a group-term life insurance plan based on the employee's compensation also does not apply.

h. Inclusion in wages

Present Law

Under present law, amounts that are includible in an employee's income because the section 89 requirements relating to employee benefit plans are not satisfied are not in all cases treated as wages (or compensation) for employment tax purposes.

Explanation of Provision

Under the bill, amounts that are includible in gross income by reason of section 89 are included in wages (or compensation), as of the time includible in gross income, for purposes of the Federal Insurance Contributions Act (sec. 3121), the Railroad Retirement Tax Act (sec. 3231(e)), the Federal Unemployment Tax Act (sec. 3306), income tax withholding (sec. 3401), and the Social Security Act (sec. 209). Of course, such inclusion is subject to the applicable limits on wages (or compensation).

i. Dependent care assistance programs

Present Law

Present law provides a benefits test applicable to dependent care assistance programs that are not treated as statutory employee benefit plans under section 89 (sec. 129(d)(8)). For purposes of applying this benefits test to salary reduction amounts, employees with compensation (as defined in sec. 414(q)(7)) below $25,000 are to be disregarded. This special rule does not apply if the dependent care assistance program is treated as a statutory employee benefit plan under section 89.

Explanation of Provision

For purposes of applying the special benefits test (sec. 129(d)(7), as redesignated by the bill) to salary reduction amounts under a dependent care assistance program that is not treated as a statutory employee benefit plan under section 89, an employer may elect to take into account employees with compensation (as defined in sec. 414(q)(7)) below $25,000. Thus, the employer may elect to take into account all employees with compensation below $25,000 or may disregard employees with compensation below any specified amount lower than $25,000. This rule is provided so that an employer may elect to take into account all nonhighly compensated employees in applying the special benefits test.

j. Cafeteria plans

Present Law

Definition of a cafeteria plan

Under present law, the definition of a cafeteria plan includes a plan only offering a choice between nontaxable benefits (sec. 125).

Qualified benefits

To qualify as a cafeteria plan, a plan may not offer benefits other than cash and qualified benefits. The term "qualified benefits" generally means any benefit that, with the application of section 125(a), is excludable from an employee's income by reason of a provision of Chapter 1 of the Code (other than secs. 117, 124, 127, or 132). In addition, the term includes (1) any group-term life insurance coverage that is includible in income only because it is in excess of $50,000, and (2) any other benefit permitted under regulations.

Explanation of Provision

Definition of a cafeteria plan

The bill amends the definition of a cafeteria plan so that a choice between nontaxable benefits is not a cafeteria plan. The inclusion of a choice between nontaxable benefits as a cafeteria plan would require, to make the provision effective as a practical matter, additional amendments not intended by Congress. For example, under present law, a choice between nontaxable benefits, one of which constituted deferred compensation, would generally not be a cafeteria plan in light of the prohibition on deferred compensation in a cafeteria plan. Thus, an employer could simply add to any choice between nontaxable current benefits the choice of a nominal nontaxable deferred benefit; this would at least arguably remove the arrangement from the definition of a cafeteria plan. Although this and other problems with the new definition could have been individually addressed with additional rules, such rules would have added complexity not contemplated by Congress.

Sanctions

The bill also clarifies that, in the case of a cafeteria plan that fails the cafeteria plan nondiscrimination test (sec. 125(b)(1)), only highly compensated employees are taxable on the available taxable benefits. In the case of a cafeteria plan that fails the key employee concentration test (sec. 125(b)(2)), the bill clarifies that only key employees are taxable on the available taxable benefits.

Qualified benefits

In addition, the bill modifies the definition of qualified benefits. Under the bill, the term "qualified benefits" includes benefits that would be qualified benefits but for the fact that they are includible in an employee's income under section 89. Thus, if, for example, there is a discriminatory excess with respect to a health plan offered under a cafeteria plan, such discriminatory excess will not cause the cafeteria plan to cease to be a cafeteria plan.

k. Continuation of health care

Present Law

Under present law, for purposes of most employee benefit provisions, certain aggregation rules are applied (sec. 414(b), (c), (m), (o), and (t)). Thus, related employers generally are treated as a single employer for purposes of these provisions. Further, under certain circumstances, leased employees may be treated as employees of the lessee (sec. 414(n)).

Explanation of Provision

The bill extends the rules aggregating related employers (sec. 414(b), (c), (m), (o), and (t)) and the employee leasing rules (sec. 414(n)) to the continuation-of-health-care rules under section 162(i)(2) and 162(k) and under section 2201(b) of the Public Health Service Act. (The Act applied such aggregation and leasing rules for purposes of the continuation-of-health-care rules under sec. 106

and the Employment Retirement Income Security Act of 1974 (ERISA).) Such extension presents evasion of the continuation-of-health-care rules by the use of multiple employers, employee leasing, or other arrangements.

Under the bill, this extension and the application under the Act of the same aggregation and leasing rules to section 106 (relating to the exclusion from income of employer-provided accident or health coverage) and to the continuation-of-health-care rules of ERISA are effective for years beginning after 1986.

l. Effective date

Present Law

In general, the amendments made by section 1151 of the Act, which provide the new rules regarding nondiscrimination, dependent care assistance programs, cafeteria plans, qualification, and reporting generally are effective for years beginning after the later of—

(1) December 31, 1987, or

(2) the earlier of—

(a) the date that is 3 months after the date on which the Secretary issues regulations under section 89, or

(b) December 31, 1988.

Explanation of Provision

Under the bill, an employer may elect to apply the new rules of section 1151 of the Act (including the nondiscrimination rules, qualification rules, reporting rules, and cafeteria plan rules) to certain group-term life insurance plans in plan years beginning after October 22, 1986. The plans for which this election is available are described in section 125(c)(2)(C).

2. Deductibility of health insurance costs of self-employed individuals (sec. 111B(b) of the bill, sec. 1161 of the Reform Act, and sec. 162(m) of the Code)

Present Law

Under certain circumstances, a self-employed individual may deduct 25 percent of the amounts paid for health insurance for a taxable year on behalf of the individual and the individual's spouse and dependents (sec. 162(m)). The deduction is allowable in calculating adjusted gross income.

Explanation of Provision

The bill clarifies that, consistent with the Congressional intent reflected in the Statement of Managers, the amount deductible under section 162(m) is not taken into account in computing net earnings from self-employment (sec. 1402(a)). Therefore, the amounts deductible under section 162(m) do not reduce the income base for the self-employed individual's social security tax.

3. Treatment of certain full-time life insurance salespersons (sec. 111B(e) of the bill, sec. 1166 of the Reform Act, and sec. 7701(a)(20) of the Code)

Present Law

Under present law, a full-time life insurance salesperson is treated as an employee for purposes of the cafeteria plan provision with respect to accident and health plans.

Explanation of Provision

The bill clarifies Congressional intent, reflected in the Statement of Managers, to treat full-time life insurance salespersons as employees for purposes of the cafeteria plan provision with respect to benefits that the salesperson is otherwise permitted to exclude from income.

4. Exclusion of cafeteria plan elective contributions from wages for purposes of employment taxes (sec. 111B(a) of the bill, sec. 1151(d) of the Reform Act, sec. 209(e) of the Social Security Act, and secs. 3121(a)(5) and 3306(b)(5) of the Code)

Present Law

Under present law, no amount is included in the gross income of a participant in a cafeteria plan meeting certain requirements solely because, under the plan, the participant may choose among the benefits of the plan. Under the Act, this exception from the principles of constructive receipt generally also applies for purposes of FICA and FUTA taxes. The exception does not apply, however, for FICA and FUTA tax purposes with respect to elective deferrals under a qualified cash or deferred arrangement that is part of a cafeteria plan.

Explanation of Provision

The bill clarifies that the exclusion from wages provided under the Act with respect to FICA and FUTA taxes is limited to payments under a cafeteria plan that are excludable from gross income and that would not be treated as wages if provided outside of the cafeteria plan. Thus, for example, no amount is included in an employee's wages for FICA and FUTA tax purposes attributable to the employee's election of a health benefit under a cafeteria plan if no amount is included in the employee's income with respect to such election.

5. Tax treatment of qualified campus lodging (sec. 111B(d) of the bill, sec. 1164 of the Reform Act, and sec. 119(d) of the Code)

Present Law

Under present law, the fair market value of use (on an annualized basis) of qualified campus lodging furnished by, or on behalf of, an educational institution (within the meaning of sec. 170(b)(1)(A)(ii)) is treated as not greater than 5 percent of the appraised value for the lodging, but only if an independent appraisal of the fair market value of the lodging is obtained by a qualified appraiser under rules prescribed by the Secretary. For purposes of this rule, the appraised value is to be determined as of the close of the calendar year in which the taxable year begins.

The purpose of this provision is to avoid disputes between educational institutions and the Internal Revenue Service regarding whether an individual has income attributable to the use, for a specified rent, of employer-furnished lodging located on a campus of, or in the proximity of, the educational institution.

Explanation of Provision

If the appraised value of qualified campus lodging is determined as of the close of the calendar year in which the taxable year begins, the 5-percent ceiling on the value of use of such lodging may not be known until after the beginning of the rental period and thus after the rent for the lodging has been established. The result may be that the rent chosen is below the 5-percent ceiling, which may give rise to income for the individual using the lodging.

The bill modifies the date on which the appraised value is determined in the case of a rental period not greater than 1 year. In such case, the appraised value may be determined at any time during the calendar year in which the rental period begins.

6. Military fringe benefits (sec. 111B(f) of the bill, sec. 1168 of the Reform Act, and sec. 134 of the Code)

Present Law

Under present law, qualified military benefits are excludable from gross income. The term "qualified military benefit" generally means any allowance or in-kind benefit that—

(1) is received by any member or former member of the uniformed services of the United States or any dependent of such member by reason of such member's status or service as a member of such uniformed services, and

(2) was excludable from gross income on September 9, 1986, under any provision of law or regulation thereunder that was in effect on such date (other than a provision of Title 26).

For purposes of the exclusion of qualified military benefits that are payable in cash, certain adjustments to such benefits after September 9, 1986, are to be disregarded and thus are not to be covered by the section 134 exclusion.

Of course, benefits provided in connection with an individual's status or service as a member of the uniformed services may be excluded from income under other sections of the Code if the requirements for exclusion under such other sections are satisfied, even if such benefit does not qualify as a qualified military benefit.

Explanation of Provision

The bill clarifies that, with respect to the definition of qualified military benefit, the exclusion on September 9, 1986, may have been by administrative practice, in addition to by law or regulation.

The bill also provides that the term "qualified military benefit" does not include personal use of a vehicle. This amendment applies to taxable years beginning after December 31, 1986.

Under the bill, it is further intended that qualified military benefits that are provided in kind may be modified or adjusted after September 9, 1986, without affecting the excludability of such benefit under section 134.

In addition, the bill modifies the general effective date of section 134 to apply to taxable years beginning after December 31, 1984 (rather than beginning after December 31, 1986).

G. Employee Stock Ownership Plans (ESOPs)

An employee stock ownership plan (ESOP) is a qualified stock bonus plan or a combination of a stock bonus and a money purchase pension plan under which employer stock is held for the benefit of employees. The stock, which is held by 1 or more tax-exempt trusts under the plan, may be acquired through direct employer contributions or with the proceeds of a loan to the trust (or trusts) that is exempt under section 4975. An ESOP is required to be designed to be invested primarily in employer securities.

1. Changes in qualification requirements relating to ESOPs (sec. 111B(i), (j), and (k) of the bill, secs. 1174-1176 of the Reform Act, and secs. 401, 415, and 409 of the Code)

a. Diversification of investments

Present Law

The Act requires an ESOP to offer a partial diversification election to participants who meet certain age and participation requirements (qualified participants). Under the Act, a qualified participant is entitled annually during any diversification election period following each plan year in the participant's qualified election period to direct diversification of up to 25 percent of the participant's account balance (50 percent in the last election period).

Under the Act, an ESOP is required to provide an annual diversification election period for the 90-day period following the close of the ESOP plan year. Thus, for 90 days after the end of a plan year, an ESOP is to permit an election by those qualified participants who become or remain eligible to make a diversification election during the plan year. Under the Act, any participant who has attained at least age 55 and completed at least 10 years of participation in the plan is a qualified participant. A qualified participant may modify, revoke, or make a new election at any time during the 90-day election period. Any qualified participant is permitted to make a diversification election during each diversification election period following each plan year in the participant's qualified election period.

No later than 90 days after the close of the election period, the plan is to complete diversification pursuant to participant elections. The diversification requirement can be satisfied by (1) offering to distribute to the participant an amount equal to the amount for which the participant elected diversification, (2) substituting for the amount of the employer securities for which the participant elected diversification an equivalent amount of other assets, in accordance with the participant's investment direction, or (3) providing the participant the option to transfer (in accordance with applicable qualification rules) the portion of the account balance for which diversification is elected into a qualified plan that provides for employee-directed investment and in which the required diversification options are available. The ESOP, or the transferee plan in the case of a transfer described in (3), is to offer at least 3 investment options (not inconsistent with regulations prescribed by the Secretary).

Explanation of Provision

In order to conform to Congressional intent, the bill clarifies that a qualified participant's qualified election period generally begins with the plan year during which the participant attains age 55 and ends with the fifth succeeding plan year. If, however, the participant has not completed 10 years of plan participation by the end of the plan year in which the participant attains age 55, the qualified election period begins with the plan year in which the participant completes 10 years of plan participation and ends with the fifth succeeding plan year.

For example, in the case of an ESOP using the calendar year as the plan year, a participant who completes 10 years of plan participation before attaining age 55 and who attains age 55 in 1990, becomes a qualified participant in the plan year beginning January 1, 1990. That participant is eligible to direct diversification during the 90-day election period beginning January 1, 1991, and remains eligible to direct diversification during the annual election periods in 1992, 1993, 1994, 1995, and 1996.

Similarly, if the participant completes 10 years of participation in 1990 when the participant is 58, the participant becomes a qualified participant in the plan year beginning January 1, 1990. The participant is eligible to direct diversification during the election periods in 1991, 1992, 1993, 1994, 1995, and 1996.

Under the bill, the qualified election period of any participant does not begin before the first plan year beginning after December 31, 1986. Thus, for example, under the bill, if a participant in a calendar year ESOP attained age 55 and had 10 years of plan participation in 1986, the participant is eligible to make a diversification election during the election periods in 1988, 1989, 1990, 1991, 1992, and 1993.

The bill also clarifies that diversification is to be completed no later than 90 days after the close of the election period, regardless of the method used to implement diversification elections. Thus, diversification is to be completed within the 90-day period regardless of whether diversification is implemented by means of distribution, transfer to another qualified plan which offers the requisite investment options, or reinvestment of employer securities in other assets.

b. Distributions from tax-credit ESOPs

Present Law

An ESOP under which an employer contributes employer securities (or cash with which to acquire employer securities) in order to qualify for a credit against income tax liability is referred to as a tax-credit ESOP. This credit was initially investment-based (and the plans were called TRASOPs due to their origin in the Tax Reduction Act of 1975), but was payroll-based after 1982 (and the plans were called PAYSOPs). The Act repealed the credit with respect to compensation paid or accrued after December 31, 1986.

Tax-credit ESOPs are subject to the requirements generally applicable to qualified plans and ESOPs. In addition, tax-credit ESOPs are subject to special qualification requirements. In general, under present law, employer securities allocated to an employee's account under a tax-credit ESOP may not be distributed before the end of the 84th month after the month in which the securities were allocated. This limitation does not apply to distributions of securities in the case of the employee's separation from service death, or disability, or in the case of certain corporate acquisitions. In addition, under the Act, the 84-month rule does not apply to distributions upon termination of the tax-credit ESOP, effective with respect to plan terminations after December 31, 1984.

Explanation of Provision

The bill clarifies that the exception to the 84-month rule for distributions on termination of a tax-credit ESOP is available only with respect to lump-sum distributions (within the meaning of sec. 401(k)(10)(B)(ii) as added by the bill) upon the termination of the plan without the establishment of a successor plan. The bill also clarifies that the exception is effective with respect to distributions (rather than plan terminations) occurring after December 31, 1984.

In order to coordinate the 84-month rule with the new diversification rules, the bill provides that the 84-month rule does not apply to the extent that a distribution is made to satisfy the diversification requirement. This exception to the 84-month rule applies only to the extent that the diversification requirement cannot be satisfied by distributing employer securities that have already met the 84-month rule.

c. Timing of distributions

Present Law

The Act modified the rules relating to the timing and form of required distributions. Under the Act, an ESOP is to permit earlier distributions to employees who separate from service before normal retirement age. Unless an employee otherwise elects in writing, the payment of benefits under an ESOP is to begin no later than 1 year after the close of the plan year (1) in which the participant separates from service by reason of attainment of normal retirement age under the plan, or (2) that is the fifth plan year following the participant's separation from service for any other reason, unless the participant is reemployed by the employer before such year. The Act provided a special rule with respect to the portion of the participant's account (if any) that consists of securities acquired with an exempt loan.

The rules added by the Act accelerate the otherwise applicable benefit commencement date. Accordingly, if the general rules (secs. 401(a)(9) and 401(a)(14)) require the commencement of distributions at an earlier date, those general rules override the special ESOP rules.

Explanation of Provision

Under the special distribution rule applicable to ESOPs, the bill provides that, in the case of a separation from service for reasons other than separation on or after normal retirement age, death, or disability, distributions are not required to begin if the participant returns to service with the employer prior to the time distribution is otherwise to begin under the rule.

d. Right to demand employer securities

Present Law

A participant in an ESOP who is entitled to a distribution under the plan has the right to demand that the participant's benefits be distributed in the form of employer securities.

Explanation of Provision

To coordinate with the new diversification rules, the bill provides that a participant does not have the right to demand that benefits be paid in the form of employer securities with respect to the portion of the participant's account that the participant elected to diversify.

e. Voting

Present Law

An ESOP (or other defined contribution plan other than a profit-sharing plan) that is established by an employer whose stock is not publicly traded is generally required to pass through certain voting rights to plan participants (sec. 401(a)(22)). Under the Act, the pass-through voting requirement is eliminated with respect to employer securities issued by an employer whose stock is not publicly traded if a substantial portion of the employer's business consists of publishing a newspaper for general circulation on a regular basis.

Explanation of Provision

The bill incorporates in the statute the provision in the Statement of Managers that the exception to the voting rules applies to an employer (determined without regard to the controlled group rules) whose business consists of publishing a newspaper for general circulation on a regular basis. Thus, the exception does not apply to members of the controlled group that do not meet this requirement.

The bill replaces the term "not publicly traded" in section 401(a)(22) with the term "not readily tradable on an established market" to conform to the term used in section 409.

2. Estate tax deduction for sales to an ESOP[6] (sec. 111B(g) of the bill, sec. 1172 of the Reform Act, and secs. 409 and 2057 of the Code)

Present Law

The Act permits a deduction from the gross estate of 50 percent of the qualified proceeds from a qualified sale of employer securities. Under the Act, a qualified sale means any sale of employer securities (within the meaning of sec. 409(1)) by an executor to (1) an ESOP described in section 4975(e)(7), or (2) an eligible worker-owned cooperative (as defined in sec. 1042(c)(2)).

Under the Act, certain penalties apply if any portion of the assets attributable to employer securities acquired in a qualified sale (or assets in lieu thereof) accrue or are allocated during the nonallocation period for the benefit of (1) a decedent whose estate makes such a sale, (2) any person who is related to the decedent in one of the ways described in section 267(b), or (3) any other person who owns (after application of the attribution rules of sec. 318(a) as modified for this purpose) more than (a) 25 percent (by number) of any class of outstanding stock of the corporation (or certain related corporations) that issued such qualified securities, or (b) more than 25 percent of the total value of any class of outstanding stock of the corporation (or certain related corporations).

There are 2 sanctions for failure to comply with the allocation restriction. First, the Act requires that an ESOP that acquires securities in a qualified sale is required to provide that the restriction on the allocation of securities (or assets in lieu thereof) to the sellers, family members, and 25-percent shareholders will be satisfied. Failure to comply with this requirement results in disqualification of the plan with respect to those participants who received prohibited allocations. Thus, failure to comply results in income inclusion for those participants of the value of their prohibited allocations on the date of such allocations. Second, if there is a prohibited allocation or accrual, then a 50 percent excise tax is imposed on the amount involved in the prohibited allocation (sec. 4979A).

Explanation of Provision

The bill conforms the nonallocation rules applicable to sales under section 2057 to the nonallocation rules applicable to sales under section 1042 (relating to nonrecognition treatment for certain sales of stock to an ESOP). With respect to the rule prohibiting allocation or accrual of benefits under a plan attributable to securities acquired in a qualified sale (or assets in lieu of such securities), the bill clarifies that the nonallocation period is the period beginning on the date of the sale and ending on the date that is 10 years after the later of (1) the date of sale or (2) the date of the plan allocation attributable to the final payment of acquisition indebtedness incurred in connection with such sale.

---

[6] H.R. 1311 and S. 591 (100th Cong.) would make modifications to sec. 2057. The modifications are designed to conform the provision to Congressional intent and to reduce the revenue loss of the provision to the original level estimated during consideration of the Tax Reform Act of 1986.

The bill also provides that individuals who are ineligible to receive an allocation of securities (or other assets) solely because they are lineal descendants of the decedent can receive an allocation of the securities acquired in the qualified sale provided that the total amount of such securities (or assets in lieu thereof) allocated to all such lineal descendants is not more than 5 percent of all employer securities acquired in the qualified sale.

Finally, the bill clarifies that, in the case of a plan which fails to comply with the nonallocation rules, the statutory period for the assessment of the excise tax imposed with respect to such failure (sec. 4979A) is extended.

3. Partial exclusion of interest earned on ESOP loans (sec. 111B(h) of the bill, sec. 1173 of the Reform Act, and sec. 133 of the Code)

Present Law

In general

Under present law, a bank, an insurance company, regulated investment company, or a corporation actively engaged in the business of lending money may exclude from gross income 50 percent of the interest received with respect to a securities acquisition loan. A "securities acquisition loan" is generally defined as a loan to a corporation or to an ESOP to the extent that the proceeds are used to acquire employer securities (within the meaning of section 409(1)) for the ESOP. There has been some confusion as to the availability of the partial interest exclusion with respect to refinancings of the various types of securities acquisition loans.

Back-to-back loans

The Act clarified the definition of a securities acquisition loan in the case of a loan to a corporation with a corresponding loan to an ESOP that is exempt under section 4975 (a back-to-back loan). The Act provides that a loan to a sponsoring corporation will qualify as a securities acquisition loan if the terms of such loan are substantially similar to the terms of the corresponding exempt loan from the corporation to the ESOP. In addition, the Act provides that, if the terms of the 2 loans are not substantially similar, the loan to the sponsoring corporation will still qualify as a securities acquisition loan if (1) the corresponding loan to the ESOP provides for more rapid payment of principal or interest than the loan to the sponsoring corporation; (2) the allocations of stock within the ESOP attributable to the difference in payment schedules do not result in discrimination in favor of highly compensated employees; and (3) the total commitment period of the loan to the sponsoring corporation is not more than 7 years.

The 7-year limitation applies to the total commitment period. Thus, provided the final maturity of the credit arrangement is not greater than 7 years, the funds may be provided by 1 or more lenders in a series of shorter maturity loans, each of which (other than the first) is used to repay the preceding loan.

The 7-year limitation on the term of the loan does not apply to loans directly from a commercial lender to an ESOP or to back-to-back loans if the terms of the loans are substantially similar. For example, assume a bank makes a loan to employer X with a term of 10 years and employer X in turn makes a loan to its ESOP. If the terms of the 2 loans are substantially similar, then the partial interest exclusion is available for the entire 10-year commitment period of the loan. Similarly, the partial interest exclusion applies for the entire commitment period of the loan if the loan is made directly from the bank to the ESOP.

Immediate allocation loans

The Act extended the definition of "securities acquisition loan" to include certain loans to a corporation that are used by the corporation to purchase employer securities that are immediately allocated to employees' accounts. Thus, the partial exclusion is available with respect to interest paid on a loan to a corporation to the extent that (1) within 30 days of the date of the loan, employer securities are transferred to the ESOP in an amount equal to the proceeds of the loan, (2) such contributions are allocable to accounts of plan participants within 1 year of the date of the loan, and (3) the total commitment period of the loan does not exceed 7 years.

As in the case of other loans to which the 7-year limitation applies, the limitation applies to the total commitment period. Thus, provided the final maturity of the credit arrangement is not greater than 7 years, the funds may be provided by 1 or more lenders in a series of shorter maturity loans, each of which (other than the first) is used to repay the preceding loan.

Refinancings

The Act provided that, in certain cases, the refinancing of a securities acquisition loan (other than an immediate allocation loan or a back-to-back loan that has terms that are not substantially similar, which are discussed above) may also qualify as a securities acquisition loan.

All refinancings, including refinancings of back-to-back loans that are not substantially similar, are required to comply with section 4975.

Explanation of Provision

In general

The bill clarifies the availability of the partial interest exclusion in the case of refinancings of the various types of securities acquisition loans.

Back-to-back loans

The bill provides that, with respect to back-to-back loans the terms of which are not substantially similar, if the total commitment period of the loan is extended beyond 7 years, the partial exclusion will be available, but for the first 7 years of the loan only. This 7-year period begins as of the date of the original loan. The provision is effective with respect to a loan used to acquire employer securities after July 18, 1984, and a loan made after July 18, 1984, that is used (or is part of a series of loans used) to refinance a loan that (1) was used to acquire employer securities after July 18, 1984, and (2) met the requirements of section 133 of the Code as in effect at the time the loan was made.

Immediate allocation loans

The bill provides that, with respect to immediate allocation loans, if the total commitment period is extended beyond 7 years, the partial interest exclusion will be available, but for the first 7 years of the loan only. This 7-year period begins as of the date of the original loan. This provision is effective as if included in the Act.

Refinancings

The bill provides that a loan to an ESOP (other than an immediate allocation loan or a back-to-back loan that has terms that are not substantially similar) after July 18, 1984, that is used (or is part of a series of loans used) to refinance a loan will qualify as a securities acquisition loan provided that (1) the original loan met the requirements of section 133(b)(1) as in effect on the date of the loan, or, if later, July 19, 1984; and (2) the original loan was used to acquire employer securities after May 23, 1984. Immediate allocation loans and back-to-back loans which have terms that are not substantially similar are described above.

Under the bill, if a securities acquisition loan (other than an immediate allocation loan or a back-to-back loan that has terms that are not substantially similar) is refinanced and as a result the total commitment period exceeds the greater of the original commitment period or 7 years, then the partial exclusion would continue to apply, but only during the first 7 years of the commitment period (measured from the date of the original loan) or the original commitment period, whichever is greater. For example, if an otherwise qualified securities acquisition loan to an ESOP with an original commitment period of 5 years is refinanced and the commitment period is extended for 2 years (for a total commitment period of 7 years), the partial exclusion would apply during the entire 7 years of the loan.

Under the bill, as under the Act, if the terms of the back-to-back loans are no longer substantially similar as a result of the refinancing, the partial exclusion would be available only during the first 7 years of the loan.

4. Sales of stock to an ESOP (sec. 118(q) of the bill, sec. 1854 of the Reform Act, and secs. 404, 409, and 1042 of the Code)

Present Law

A taxpayer may elect to defer recognition of gain on the sale of certain qualified securities to an ESOP or to an eligible worker-owned cooperative to the extent that the taxpayer reinvests the proceeds in qualified replacement property within a replacement period (sec. 1042).

Prior to the Act, nonrecognition treatment was not available if any portion of the assets attributable to employer securities acquired in a qualified sale (or assets in lieu thereof) accrued or were allocated during the nonallocation period for the benefit of (1) the taxpayer involved in the nonrecognition transaction, (2) any member of the taxpayer's family (within the meaning of sec. 267(b)), or (3) any other person who owned (after application of the sec. 318 attribution rules) more than 25 percent in value of any class of outstanding securities. Temporary Treasury regulations provided that, for purposes of determining whether an individual is a 25-percent shareholder, stock that is owned directly or indirectly by or for a qualified plan is not treated as outstanding (Temp. Treas. reg. sec. 1042-1T Q&A 2(a)(3)).

The Act made several changes with respect to the nonallocation requirement. In particular, for purposes of determining whether an individual is a 25-percent shareholder, the Act provides that the allocation rules of section 318(a) are applied, without regard to the employee trust exception in paragraph (2)(B)(i). Thus, all allocated securities held by an ESOP are treated as securities owned by the ESOP participant and are also treated as outstanding securities. This provision is effective with respect to sales of securities after October 22, 1986.

An excise tax is imposed with respect to certain dispositions of employer securities within 3 years of the date of a sale to which section 1042 applies (sec. 4978).

Explanation of Provision

In order to conform the statute to Congressional intent, the bill clarifies that the nonallocation period is the period beginning on the date of the sale and ending on the date that is 10 years after the later of (1) the date of sale or (2) the date of the plan allocation attributable to the final payment of acquisition indebtedness incurred in connection with such sale.

In some situations, the rules for determining whether an individual is a 25 percent shareholder may be more favorable under the Act than under prior law. The provision of the Act, however, is effective prospectively only. The bill provides that, for purposes of determining whether an individual is a 25-percent shareholder with respect to sales occurring before October 22, 1986, in taxable years beginning after July 18, 1984. all allocated securities held by an ESOP for an individual may be treated as outstanding with respect to the individual if securities allocated to the individual under the ESOP are treated as securities owned by the individual. This rule applies consistently to all individuals with respect to any sales to which section 1042 applies.

The bill provides that the excise tax on certain distributions (sec. 4978) does not apply to employer securities which are required to be disposed of pursuant to the new diversification rules.

5. Dividends paid deduction (sec. 111B(h) of the bill, sec. 1173 of the Reform Act, and sec. 404(k) of the Code)

Present Law

Subject to certain requirements, an employer may deduct dividends paid in cash on employer stock held by an ESOP if, in accordance with the plan provisions, (1) the dividend is paid in cash to the plan participants or their beneficiaries, (2) the dividend is paid to the plan and distributed to participants or beneficiaries not later than 90 days after the close of the plan year in which paid, or (3) the dividend with respect to employer securities is used to make payments on a loan described in section 404(a)(9) (sec. 404(k)).

Explanation of Provision

The bill provides that, with respect to dividends used to make payments on a loan described in section 404(a)(9), the dividend deduction is available both with respect to dividends on unallocated and allocated shares. However, dividends on allocated shares may be used to make payments on such a loan only if the account to which the dividend would have been allocated is allocated employer securities in an amount equal to the amount of the dividend that would have been allocated. In addition, such allocation must be made in the year the dividend would otherwise have been allocated.

H. Technical Corrections to the Retirement Equity Act of 1984 (sec. 118(q) of the bill, sec. 1898 of the Reform Act, sec. 417 of the Code, and sec. 205 of ERISA)

Present Law

Under present law, a plan is required to notify participants of their rights to decline a qualified preretirement survivor annuity before the applicable election period. Under the Act, the period during which notice is required to be provided to an individual is the latest of the following periods: (1) the period beginning with the first day of the plan year in which the participant attains age 32 and ending with the close of the plan year in which a participant attains age 35; (2) a reasonable period of time after the individual becomes a plan participant; (3) a reasonable period of time after the survivor benefit applicable to a participant is no longer subsidized (as defined in sec. 417(a)(4); (4) a reasonable period of time after the survivor benefit provisions (sec. 401(a)(11)) become applicable with respect to a participant; or (5) a reasonable period after separation from service in the case of a participant who separates from service before attaining age 35.

Explanation of Provision

The bill clarifies that the notice period in the case of a participant who separates from service before age 35 overrides any other period during which notice might be required. In such a case, the bill provides that the notification period is a reasonable period after separation from service and such notice period is not included in the list of notice periods the last of which applies.

This provision is effective for distributions after the date of enactment of the bill.

XII. Foreign Tax Provisions (Sec. 112 of the Bill)

A. Foreign Tax Credit (sec. 112(a)-(c) of the bill, secs. 1201, 1202, and 1203 of the Reform Act, and secs. 864, 902, and 904 of the Code)

Under the foreign tax credit system, the United States reserves the right to collect full U.S. income tax on U.S. persons' foreign income, less any foreign income taxes imposed on that income. The mechanics of the foreign tax credit are such that the United States may collect little or no residual U.S. tax—after aggregate foreign taxes are credited—on income that is taxed abroad at below the U.S. rate. This results where the law permits a cross-crediting of taxes, sometimes referred to as "averaging": that is, where taxpayers are permitted to credit high foreign taxes paid on one stream of income against the residual U.S. tax otherwise due on other, lightly taxed foreign income.

While the Code does not and has not attempted to eliminate all cross-crediting among types of differently taxed income, it has in the past separated types of income for credit purposes, most recently based on the character, rather than the country of origin, of income. The Act further separated certain income into the following newly defined "baskets": passive income, high withholding tax interest, financial services income, shipping income, and dividends from each noncontrolled section 902 corporation.

1. Separate application of foreign tax credit provisions to financial services income

Present Law

The "predominantly engaged" test and the priority of the financial services income basket

The financial services income basket applies not only to income earned by an entity *predominantly engaged* in the active conduct of a banking, insurance, financing, or similar business, but also to income earned by a person in the active conduct of a banking, financing, or similar business, or earned in connection with certain insurance activities, even if that person is not predominantly so engaged. The types of income that the Act places in the financial services income basket of a "predominantly engaged" entity are not limited to the types of income included in the financial services basket of a person not predominantly engaged. For example, income that would otherwise be passive is treated as financial services income in the hands of a predominantly engaged entity, but remains passive in the hands of an entity that is not predominantly engaged.

On the other hand, Congress intended that dividends from each noncontrolled section 902 corporation would be subject to their their own separate limitation regardless of whether those dividends also met the definition of financial services income (or of passive income or shipping income or of any other separate limitation type of income).

Generally, the Act places certain export financing interest in the overall limitation basket, that is, outside the separately defined limitation baskets, regardless of whether the entity deriving the interest is engaged in financial services. In addition, the financial services income basket excludes high withholding tax interest. Where a predominantly engaged entity earns interest qualifying as export financing interest that is subject to a 5-percent or greater gross basis tax, however, Congress intended that such interest be treated as financial services income.

Modification of the look-through rule to prevent avoidance of the purpose of the separate limitations

Under the Act's look-through provisions for characterizing certain types of income that a U.S. shareholder derives from a controlled foreign corporation, interest income of the shareholder is generally to be treated as financial services income (without regard to high withholding taxes or other circumstances that would ordinarily shift such interest out of the shareholder's financial services income basket) to the extent that the interest payment is properly allocable to financial services income of the controlled foreign corporation. At the same time, the Act requires the IRS to prescribe such regulations as may be necessary or appropriate to prevent manipulation of the character of income the effect of which is to avoid the purposes of the separate limitations. In granting this regulatory authority Congress intended that the IRS invoke it to modify, in some cases, the application of the look-through rule.

For example, if a U.S. person lends funds directly to an unrelated foreign person whose country of residence imposes a withholding tax of at least 5 percent on the interest paid on the loan, then the interest is high withholding tax interest subject to the separate limitation for such interest. United States banks might take the position, however, relying upon the look-through rule for interest, that they can avoid the separate limitation for high withholding tax interest by lending funds to such a borrower through a subsidiary that is a controlled foreign corporation incorporated in the borrower's country, rather than lending those funds directly. Taxpayers might argue that, under the look-through rule for interest, interest received in turn by the U.S. bank from the foreign subsidiary will not be high withholding tax interest, even though it attracts the foreign country's high withholding tax.

Because such a result would undermine the separate limitation for high withholding interest, Congress intended that it be precluded under the anti-avoidance regulations. It was expected that such regulations might treat the interest received by the U.S. bank from the foreign subsidiary in this example as high withholding tax interest.

Overall basket treatment of highly taxed financial services income of a controlled foreign corporation

Where the taxpayer establishes to the satisfaction of the Secretary, pursuant to Code section 954(b)(4), that income of a controlled foreign corporation was taxed at over 90 percent of the maximum federal rate, the Act provides that dividends paid by the controlled foreign corporation out of its financial services income (as well as dividends paid out of the controlled foreign corporation's passive income and shipping income) are to be treated as overall basket income to the taxpayer.

Explanation of Provision

The predominantly engaged test and the priority of the financial services income basket

Under the bill only income of persons predominantly engaged in the active conduct of a banking, insurance, financing, or similar business is separated into the financial services income basket. The bill therefore simplifies the foreign tax credit somewhat, relieving taxpayers from the necessity of computing a separate limitation with respect to a very limited type of income (i.e., non-passive, financial service income of an entity not predominantly engaged in providing such services) that generally could be expected to yield relatively insignificant amounts of additional tax revenues.

The bill clarifies that dividends from a noncontrolled section 902 corporation which would otherwise meet the definition of financial services income are placed in the separate basket for that corporation's dividends. Thus the bill prevents banks and other financial businesses from receiving unintended relief from the 902 basket provisions not available to non-financial businesses.

Where a predominantly engaged U.S. person earns export financing interest (as defined by the Act) that is subject to a 5-percent or greater gross basis tax, the bill clarifies that this interest is financial services income, rather than overall limitation income. In general, this treatment makes it clear that the Code allows cross-crediting of high taxes on such income against U.S. tax on lower-taxed financial services income, supplementing the favored treatment provided in the Act that allows cross-crediting of high taxes on overall basket income against U.S. tax on lower-taxed export financing interest.

Modification of the look-through rule to prevent avoidance of the purpose of the separate limitations

The bill eliminates the look-through treatment of interest subject to 5-percent or greater gross basis tax that is paid to a U.S. shareholder by a controlled foreign corporation out of income that would otherwise be treated under the look-through rules as financial services income. This provision makes it clear that lenders are prevented from shifting high withholding tax interest into the financial services basket by the mere interposition of a controlled local entity between themselves and foreign borrowers.

Overall basket treatment of highly taxed financial services income of a controlled foreign corporation

The bill provides for separate basket treatment of dividends paid by controlled foreign corporations where paid out of the latter's financial services income (or shipping income), even where it has been established pursuant to section 954(b)(4) that the controlled foreign corporation's income was taxed by a foreign government at more than 90 percent of the maximum U.S. rate. Thus, for example, a dividend from a highly taxed banking subsidiary will be available for cross-crediting against U.S. tax on other lower-taxed financial services income of the parent.

2. Shipping income

Present Law

The Act establishes a separate foreign tax credit limitation for shipping income. This limitation applies to income received or accrued by any person which is of a kind that would be foreign base company shipping income under Code sec. 954(f). The Act did not provide express ordering rules to determine the correct basket for income that could be placed in the shipping basket or a basket for dividends from a noncontrolled section 902 corporation. However, as indicated above, Congress intended the baskets for section 902 corporations to take priority over the shipping basket.

As in the case of financial services income described above, where the taxpayer establishes to the satisfaction of the Secretary that income of a controlled foreign corporation was taxed at over 90 percent of the maximum federal rate, the Act provides that dividends paid by the controlled foreign corporation out of its shipping income are to be treated as overall basket income to the taxpayer.

Explanation of Provision

The bill provides that dividends from a noncontrolled section 902 corporation that might otherwise constitute shipping income are to be placed in that corporation's dividend basket rather than the shipping basket, consistent with Congress' intent generally to give first priority to the section 902 dividend baskets.

As in the case of financial services income, the bill provides for separate basket treatment of dividends paid by a controlled foreign corporation out of its shipping income when the taxpayer established to the satisfaction of the Secretary that the income was taxed by a foreign government at more than 90 percent of the maximum U.S. rate. Thus, taxpayers may cross-credit taxes on any highly taxed shipping income against the U.S. tax on other shipping income they may earn.

3. Transition rule for high withholding tax interest on qualified loans

Present Law

Generally for taxable years beginning after December 31, 1986, interest income subject to a foreign withholding tax or other gross basis tax of 5 percent or more (other than export financing interest) is "high withholding tax interest" subject to its own separate foreign tax credit treatment. A special transition rule applies, however, to certain interest on certain loans to any of 33 foreign countries or to any resident of one of those countries for use in that country. The applicability of the transition rule turns on the amount of loans held by the taxpayer on November 16, 1985 and during subsequent taxable years.

Explanation of Provision

The bill provides that for purposes of this transition rule, all members of an affiliated group of corporations filing a consolidated return shall be treated as one corporation. (Under this rule, intercompany loans are eliminated.) Thus, for members of a consolidated group, the transition relief will be available regardless of, and will be limited without regard to, the particular group member holding qualified loans on November 16, 1985, or during the relevant subsequent taxable year.

4. Passive income

Present Law

Related party factoring income

Under the related party factoring rules of the Tax Reform Act of 1984, any income of a controlled foreign corporation from a loan to a person for the purpose of financing the purchase of inventory property of a related person was interest for separate foreign tax credit limitation purposes without regard to the exceptions to prior law's separate limitation for interest. Under the 1986 Act, such income of a controlled foreign corporation is also ineligible for the export financing exception to the new separate limitations (sec. 864(d)(5)(A)(i)). In the case of passive income, this result follows because the Act defines passive income generally as income "of a kind which would be foreign personal holding company income" (Code sec. 904(d)(2)(A)(i)); if export financing interest fits that description, the related party factoring rules make unavailable the export financing exception from passive basket treatment which would otherwise be available.

Congress did not intend that the availability of the export financing exception for interest received directly by *U.S. persons* (rather than by controlled foreign corporations) be restricted by the 1984 factoring rule governing loans made to finance inventory property purchases, or by the analogous 1986 rule. However, the phrase "of a kind which would be foreign personal holding company income" arguably leads to an inference that interest income earned directly by U.S. persons (i.e., interest that would be foreign personal holding company income if the recipient was a controlled foreign corporation) is ineligible for overall basket treatment under the export financing exceptions.

Income inclusions under sections 551 and 1293

Foreign personal holding company inclusions (under Code sec. 551) and passive foreign investment company inclusions (under new Code sec. 1293) are passive income. In the case of a passive foreign investment company inclusion, Congress intended that the high-tax kick-out shift the inclusion to the overall limitation basket, however, if the creditable foreign tax with respect to the inclusion exceeds the U.S. tax on the inclusion.

Explanation of Provision

Related party factoring income

The bill clarifies that in determining whether income is "of a kind which would be foreign personal holding company income" the related person factoring rules applicable to controlled foreign corporations shall apply only in the case of an actual controlled foreign corporation. Thus, income earned directly by a U.S. person may be eligible for the applicable export financing exceptions.

Income inclusions under sections 551 and 1293

The bill amends the Code to make it clear that income inclusions under section 1293 are subject to recharacterization (e.g., by virtue of the high-tax kick-out), as are other kinds of income generally categorized as passive.

5. Separate application of foreign tax credit limitation to income of controlled foreign corporations under the look-through rules in general

Present Law

Payments by controlled foreign corporations to U.S. shareholders

A payment of interest, rent, or a royalty is ordinarily characterized as separate or overall limitation income under the general rules defining the new separate limitation categories (sec. 904(d)(2)). Under the look-through rules of new Code section 904(d)(3), however, any interest, rent, or royalty which is received or accrued from a controlled foreign corporation by a U.S. shareholder will be treated as separate category income to the extent it is properly allocable to separate category income of the controlled foreign corporation.

Without a mechanism to determine which set of rules takes precedence, the application of the look-through rules, on the one hand, and the general definitions of 904(d)(2), on the other, could produce conflicting results. For example, interest paid to a U.S. shareholder by a controlled foreign corporation earning only overall limitation income may be subject to a high withholding tax. Also, interest may be paid by a controlled foreign corporation to its U.S. shareholder to finance sales by the U.S. shareholder. On the one hand, this interest may qualify as export finance interest; on the other hand, the interest may be properly allocable to the controlled foreign corporation's income unrelated to export financing.

Congress intended that the question whether interest received from a controlled foreign corporation by a U.S. shareholder of the corporation is overall limitation income or a separate limitation type of income generally depend upon the application of the look-through rules to that interest, not upon the direct application of the export financing exception or the high withholding tax basket to that interest. In the case of high withholding tax interest, Congress expected the IRS to promulgate regulations specifying circumstances where it might be necessary to reverse the priority of the look-through rule in order to forestall abuse of the separate basket rules, as described above.

Under the high-tax kick-out of section 904, the passive income basket generally excludes high-taxed income, that is, income subject to foreign taxes paid or deemed paid by the taxpayer at rates higher than the maximum federal rates. As with financial services income and shipping income discussed above, the Act provides that for purposes of applying the dividend look-through rule, income that would otherwise be passive basket income will instead go into the overall limitation basket if the taxpayer establishes to the satisfaction of the Secretary, pursuant to Code section 954(b)(4), that such income was subject to an effective rate of income tax imposed by a foreign country greater than 90 percent of the maximum federal rate of tax.

In the case of payments of interest, rents, and royalties to the U.S. shareholder out of income of a controlled foreign corporation that would otherwise be passive, the combined effect of the look-through and high-tax kick-out rules may have been unclear.

De minimis exception

If a controlled foreign corporation has no foreign base company income or subpart F insurance income in a taxable year because the subpart F de minimis rule (Code sec. 954(b)(3)(A), as amended by the Act) is satisfied for that year, then interest, rents, or royalties paid by the corporation during that year and dividends, to the extent treated as paid from that year's earnings and profits, are not treated as income in a separate limitation category.

Explanation of Provision

Payments by controlled foreign corporations to U.S. shareholders

The bill provides a general rule that income of the U.S. shareholder allocable to separate category income of a controlled foreign corporation will retain that character in the hands of the U.S. shareholder, subject to the high-tax kick-out (and to another exception, described above, relating to interest paid by a controlled foreign corporation bearing a high withholding tax but attributable to financial services income). For example, as intended by the Act, the bill makes it explicit that interest that technically may qualify as export financing interest paid by a controlled foreign corporation to a U.S. shareholder out of the corporation's passive income will be in the shareholder's passive basket rather than its overall basket.

The bill makes it clear that the high-tax kick-out applies only at the U.S. shareholder level, not at the controlled foreign corporation level. Income of the U.S. shareholder out of the controlled foreign corporation's passive basket will be subject to the kick-out based on the entire amount of foreign tax imposed on the U.S. shareholder's income. Thus, where a withholding tax is imposed on royalties paid by a controlled foreign corporation to a U.S. shareholder out of passive income, the shareholder's income will be in the overall basket if the withholding tax is high enough to trigger the high-tax kick-out after allocation of U.S.-borne expenses.

De minimis exception

The bill limits the effect of the provision that treats income satisfying the de minimis rule as non-separate limitation income. Under the bill, this treatment applies only to the controlled foreign corporation's foreign base company income (determined without regard to deductions otherwise taken into account for subpart F purposes under sec. 954(b)(5)) and gross insurance income for the taxable year, as that term is generally used for subpart F purposes.

6. Definition of high withholding tax interest

Present Law

The Act defines high withholding tax interest generally as any interest (other than export financing interest) subject to a foreign withholding tax (or other tax determined on a gross basis) of 5 percent or more. The Act further states that the Secretary may by regulations provide that amounts (not otherwise high withholding tax interest) will be treated as high withholding tax interest where necessary to prevent avoidance of the purposes of the separate limitations. Congress intended these rules to encompass foreign gross-basis taxes and other taxes that are substantially similar in the sense that their imposition results in heavier taxation by the levying country of foreign lenders than of residents.

Explanation of Provision

The bill gives the Secretary authority to exclude from the definition of withholding taxes, for these purposes, those taxes that are in the nature of a prepayment of a tax imposed on a net basis, where the tax in question is otherwise free of those characteristics of a gross-basis tax that would warrant treatment as high withholding taxes. Thus, the bill makes clear that where a foreign taxing authority uses withholding simply as a collection mechanism (as does the United States in the cases of ordinary wage withholding and backup withholding on certain interest, dividend, and other reportable payments under Code section 3406), it will not necessarily follow that the mechanism results in interest being treated as high withholding tax interest.

7. Deemed-paid credit

Present Law

The Act clarifies that the deemed-paid credit limitation rules (Code sec. 902) and the subpart F deemed-paid limitation rules (sec. 960), as well as the general foreign tax credit limitation rules (sec. 904(a)-(c)) and the separate foreign oil and gas limitation rules (sec. 907), apply separately to categories of income subject to the separate limitations. The Act also gives the Secretary authority to provide such regulations as may be necessary or appropriate to carry out both sets of deemed-paid limitation rules, but in so doing, refers to specific authority to regulate the separate application of section

904 to deemed-paid taxes only in the case of taxes deemed paid under section 902.

The Act provides that for purposes of computing the deemed-paid foreign tax credit, dividends or subpart F inclusions are considered made first from the post-1986 pool of all the distributing corporation's accumulated earnings and profits. In the case of taxes deemed paid under section 902 on dividends, the Act defines the term "post-1986 undistributed earnings" by reference to the definitions of earnings and profits in sections 964 (prescribing rules for the computation of earnings and profits of a foreign corporation) and 986 (prescribing rules for the translation of a foreign corporation's foreign currency denominated earnings into dollars).

Section 964 has 3 subsections. Subsection 964(a) provides generally for the computation of earnings of foreign corporations in a way substantially similar to the earnings of a domestic corporation, with some exceptions. Subsection 964(b) excludes blocked income, for purposes of Code sections 952, 955, and 956, from earnings and profits of a controlled foreign corporation. Blocked income is income that is shown, to the satisfaction of the Secretary of the Treasury, to be unavailable for distribution by a controlled foreign corporation to United States shareholders due to currency or other restrictions or limitations imposed under the laws of any foreign country. Subsection 964(c) provides record-keeping and record disclosure rules for purposes of enforcing subpart F and subpart G (relating to export trade corporations).

Explanation of Provision

The bill clarifies that the Secretary's authority to provide such regulations as may be necessary to carry out the provisions of the subpart F deemed-paid credit rules in section 960 is to include authority to provide for, inter alia, the separate application of section 960 (as well as the separate application of section 902) to reflect the separate application of the section 904 rules to separate types of income and loss.

The bill amends the definition of "post-1986 undistributed earnings" under section 902, so that it will direct the computation of earnings and profits of the foreign corporation in accordance with subsection 964(a) (rather than section 964 as a whole) and section 986. Thus, the bill clarifies that the blocked income provisions of 964(b) are irrelevant to the computation of the post-1986 undistributed earnings pool for purposes of the deemed-paid credit on dividends.

8. Recapture of foreign separate limitation losses

Present Law

The 1986 Act provided express rules to make it clear that losses in the new and existing separate limitation baskets do not reduce U.S. taxable income before foreign taxable income (new Code sec. 904(f)(5)). The new rules provide that losses for any taxable year in a separate foreign tax credit limitation basket and in the overall limitation basket offset U.S. source income only to the extent that the aggregate amount of such losses exceeds the aggregate amount of foreign income earned in other baskets. These losses (to the extent that they do not exceed foreign income for the year) are to be allocated on a proportionate basis among (and operate to reduce) the foreign income baskets in which the entity earns income in the loss year.

By analogy to the overall foreign extraction loss recapture rules of section 907(c)(4), the Act further provides a loss recharacterization rule that applies to subsequent income. Where a basket previously showed a separate limitation loss which was allocated against income in other baskets, subsequent income in the loss basket will be recharacterized as income of the type that it previously offset, in proportion to the prior loss allocation not previously taken into account under this recharacterization provision.

In addition to the Act's new separate basket loss recapture provision and the overall foreign extraction loss recapture rules upon which the former is based, the Code provides a third rule, in effect since 1976, for recapture of overall foreign losses. This rule is designed to prevent taxpayers from benefiting from a combination of forgiveness of U.S. tax on a portion of current U.S. income (resulting from the use of an overall foreign loss to reduce worldwide taxable income below U.S. taxable income) and an allowance of a foreign tax credit with respect to the full amount of subsequent years' foreign income. Under the rule, a portion of foreign taxable income earned after an overall foreign loss year is treated as U.S. taxable income for foreign tax credit purposes (Code sec. 904(f)(1)-(4)).

Section 904(f)(3) contains gain recognition and characterization rules to ensure the recapture of an overall foreign loss where property which was used in a trade or business, and which was used predominantly outside of the United State, is disposed of prior to the time the loss has been recaptured by recharacterizing foreign income as U.S. taxable income. Under section 904(f)(3), gain on such a disposition is viewed as foreign source income to be recharacterized as U.S. source income until the loss is fully recaptured. Recapture occurs regardless of whether gain would otherwise have been recognized on the disposition. There is no provision analogous to section 904(f)(3) in the recapture rules for foreign oil and gas extraction losses, or in the Act's new separate limitation loss recapture provision.

Explanation of Provision

The bill adds a provision to the Act's separate loss recharacterization rules stating that recognition rules similar to those of 904(f)(3), applicable to an overall foreign loss, shall apply to any disposition of property, the gain from which would be in an income category whose separate limitation loss was allocated against any separate limitation income. Thus, the bill achieves a result consistent with the general loss recharacterization rules of the Act in the case where losses in a category have been allocated against income in the other categories, and property generating income in the loss category is disposed of at a gain (whether or not the gain would be recognized for other Code purposes) before income in the other categories has been restored to the full extent of losses allocated against them.

B. Source Rules

1. Determination of source in case of sales of personal property (sec. 112(d) and 112(z)(5) of the bill, sec. 1211 of the Reform Act, and secs. 338, 864, and 865 of the Code)

Present Law

Overview

Prior to the Act, the source of income derived from the sale of personal property generally was determined by the place of sale (commonly referred to as the "title passage" rule). While the Act did not change the place-of-sale rule for most inventory sales, the Act generally did replace the place-of-sale rule for sales of other personal property with a residence-of-the-seller rule.

Under the residence-of-the-seller rule (new sec. 865), income derived by U.S. residents from the sale of personal property, tangible or intangible, generally is sourced in the United States. Similarly, income derived by a nonresident of the United States from the sale of personal property, tangible or intangible, is generally treated as foreign source. For purposes of determining source, the term sale does not include a sale of intangible property to the extent payments received in consideration for the sale are contingent on the productivity, use, or other disposition of the property. Payments that are so contingent are treated like royalties in determining their source.

Definition of resident

An individual is a resident of the United States for purposes of section 865 if the individual has a tax home (as defined in sec. 911(d)(3)) in the United States. Any corporation, partnership, trust, or estate which is a United States person (as defined in sec. 7701(a)(30)) is a U.S. resident for this purpose. Other individuals and entities generally are nonresidents for purposes of these source rules.

Under the Act, regulations are to be prescribed by the Secretary carrying out the purposes of the Act's source rule provisions. One area where it was contemplated that regulations may be required is to prevent persons from establishing partnerships or corporations, for example, to change their residence to take advantage of the new rules. It was anticipated that the establishment of an anti-abuse rule to treat, for example, a foreign partnership as a U.S. resident to the extent its partners are U.S. persons would be appropriate.

United States citizens and resident aliens who have tax homes outside of the United States are nevertheless considered U.S. residents in one case. This case occurs when income from a sale is not subject to an effective foreign income tax of 10 percent or more.

This level-of-tax rule prevents U.S. citizens and resident aliens from generating zero- or low-taxed foreign source income that might otherwise escape all tax. As a consequence of retaining prior law's place-of-sale rule for income derived from the sale of inventory and gain in excess of recapture derived from the sale of depreciable personal property, the level-of-tax rule does not apply to sales of these types of personal property but does apply to sales of all other types of personal property.

Exceptions to residence rule

Income derived from the sale of depreciable personal property

The residence-of-the-seller rule does not apply to income derived from the sale of depreciable personal property, to the extent of prior depreciation deductions. This income is sourced under a recapture principle. Specifically, gain to the extent of prior depreciation deductions from the sale of depreciable personal property is sourced in the United States if the depreciation deductions giving rise to the gain were previously allocated against U.S. source income. If the deductions giving rise to the gain were previously allocated against foreign source income, gain from the sale (to the extent of prior deductions) is sourced foreign. If personal property is used predominantly in the United States for any taxable year, the taxpayer is to treat the allowable deductions for the year as being allocable entirely against U.S. source income. If personal property is used predominantly outside the United States for any taxable year, the taxpayer is to treat the allowable deductions for such year as being allocable entirely against foreign source income. (This special predominant-use rule does not apply for certain personal property generally used outside the United States, namely, personal property described in sec. 48(a)(2)(B).) Any gain in excess of prior depreciation deductions is sourced pursuant to the place-of-sale rule. These rules apply without regard to the residence of the taxpayer.

Depreciable personal property is any personal property if the adjusted basis of the property includes depreciation adjustments. Thus, intangible property for which an amortization deduction is allowable is considered depreciable personal property. With respect to sales of intangible property, however, it is unclear under the Act whether the recapture rule applies to gain to the extent of amortization recapture, and whether the general intangible rules or the place-of-sale rule as retained under the Act applies to gain in excess of amortization recapture.

Income attributable to an office or other fixed place of business

The residence-of-the-seller rule does not apply to income derived from the sale of personal property when the sale is attributable to an office or other fixed place of business outside the seller's residence.

For U.S. residents, this office rule applies to certain income derived from the sale of personal property when the sale is attributable to an office or other fixed place of business maintained by the taxpayer outside the United States. With respect to U.S. residents, individual or otherwise, however, the office rule applies only if an effective foreign income tax of 10 percent or more is paid to a foreign country on the income from the sale. It is unclear under the Act if the office rule applies to income (in the form of noncontingent payments) derived from the sale of intangible property by a U.S. resident when the sale is attributable to a fixed place of business in a foreign country and the U.S. resident pays an income tax at an effective rate of 10 percent or more.

Income derived from the sale of stock in foreign affiliates

The residence-of-the-seller rule does not apply to income derived by U.S. corporations from the sale ~~of stock~~ in certain foreign affiliates. If a U.S. corporation sells stock of a foreign affiliate in the foreign country in which the affiliate derived from the active conduct of a trade or business more than 50 percent of its gross income for the 3-year period ending with the close of the affiliate's taxable year immediately preceding the year during which the sale occurs, any gain from the sale is foreign source. An affiliate, for this purpose, is any foreign corporation whose stock is at least 80 percent owned (by both voting power and value). It is unclear under the Act if this rule applies only to gain from the sale of stock in corporations directly engaged in an active trade or business or also applies to gain from the sale of stock in corporations indirectly engaged in an active trade or business.

Other rules

Prior to the Act, foreign source income derived from the sale of inventory property by a foreign person generally was treated as effectively connected with the conduct of a U.S. trade or business if the sale was attributable to a U.S. office (or other fixed place of business) and sold through the U.S. office. The Act repealed this rule but generally made income derived from the sale of any personal property by a foreign person when the sale is attributable to a U.S. office (or other fixed place of business) U.S. source.

The Act's legislative history indicated that Congress intended that the Act's source rule changes prevail over treaty source rules to the extent necessary to insure that income not taxed by a foreign country not escape U.S. tax as well. This policy was to apply to all the source rule changes in the Act, not just those applicable to personal property.

Section 338 generally and 338(h)(10) in particular allow in certain circumstances a sale of stock in an affiliated corporation to be treated as a sale of the affiliated corporation's assets. As indicated above, a sale of stock in a U.S. corporation is sourced under the residence-of-the-seller rule while a sale of assets is sourced under the residence-of-the-seller rule, the place-of-sale rule, the rules relating to intangible property, or the recapture rule depending on the type of asset sold and the income generated therefrom. Thus, for example, if an election under section 338(h)(10) is made, the income inherent in the stock may or may not be sourced under the residence-of-the-seller rule.

Explanation of Provision

Definition of resident

The bill modifies the definition of resident in the case of partnerships. Whereas the Act generally determined the source of income derived from sales of personal property by treating a partnership as a U.S. resident or nonresident based on its situs, the bill makes these determinations at the partner level, except as provided in regulations. In determining source, it is anticipated that, like the attribution of a U.S. trade or business under Code section 875, a U.S. office or other fixed place of business of the partnership will be attributed to its partners.

The bill provides regulatory authority to determine source at the partnership level, for example, in cases where it is not administratively possible to apply the rules at the partner level. For example, it may be appropriate to determine source at the partnership level in the case of a publicly traded partnership which has hundreds of partners.

The bill also modifies the 10-percent tax payment requirement (applicable to U.S. citizens and resident aliens maintaining tax homes outside the United States) for bona fide residents of Puerto Rico. The 10-percent tax payment requirement is waived for an individual who is a bona fide resident of Puerto Rico for the entire taxable year on the sale of stock of a corporation which (directly or indirectly) (1) is engaged in an active trade or business in Puerto Rico, and (2) derives from the active conduct of a trade or business in Puerto Rico more than 50 percent of its gross income for the 3 years preceding the year of sale. Under this rule, bona fide residents of Puerto Rico who sell stock in certain corporations doing business in Puerto Rico generate Puerto Rican source income and, thus, retain the benefits of section 933.

Exceptions to residence rule

Income derived from the sale of depreciable personal property

The bill clarifies that income to the extent of previously allowed amortization deductions derived from the sale of amortizable intangible property is sourced under the Act's recapture rule. The recapture rule applies whether or not the payments in consideration for the sale are contingent on the productivity, use, or disposition of the property. For sales where the payments are so contingent, it is intended that the source of all payments be determined under the recapture rule until the entire recapture amount has been recaptured, and that any remaining payments be sourced under the general intangible rules.

The bill also clarifies that gain derived from the sale of intangible property in excess of amortization recapture is sourced under the residence-of-the-seller rule when the payments in consideration for the sale are not contingent on the productivity, use, or disposition of the property. When payments are so contingent, the source rule for royalties applies to the gain.

Income attributable to an office or other fixed place of business

The bill clarifies that the office rule as it applies to U.S. persons also applies to a sale of intangible property when the payments in consideration for the sale are not contingent on the productivity, use, or disposition of the property. Thus, a U.S. resident who sells intangible property for noncontingent payments generates foreign source income as long as the sale is attributable to a foreign office and an effective rate of foreign income tax of at least 10 percent is paid on the income derived from the sale. Further, the bill clarifies that the recapture rule prevails over the office rule to the extent of any recapture amount.

Income derived from the sale of stock in foreign affiliates

The bill clarifies that income derived from the sale of stock of a foreign affiliate which wholly owns another foreign corporation is treated as foreign source income in certain cases. Under this clarification, as long as either the parent or the subsidiary is engaged in an active trade or business in the country in which the sale occurs and 50 percent of the gross income of the holding company and the subsidiary combined for a three-year period is derived from the active conduct of a trade or business in that foreign country, then gain on the sale of stock in the holding company will be treated as foreign source.

Other rules

The bill reinstates the provision repealed by the Act that treats foreign source income derived from certain sales of inventory property by a foreign person as effectively connected with the conduct of a U.S. trade or business. This provision is necessary to ensure that foreign persons who may be treated as U.S. residents for source rule purposes but as nonresidents for general purposes are taxed on income derived from sales of inventory property.

The bill codifies the Act's legislative history by clarifying (in connection with the changes to sec. 7852(d)) that the Act's source rule changes generally prevail over any conflicting treaty source rules under the general later-in-time rule. The bill does provide, however, an exception to the general later-in-time rule. Under this exception, if a taxpayer, by claiming treaty benefits, treats as foreign source any gain derived from the sale of stock in a treaty country corporation which would be U.S. source under the Act, then foreign taxes on that gain cannot offset U.S. tax on any other item of income, and foreign taxes on any other item of income cannot offset U.S. tax on that gain. For example, under the Act, gain from the sale of stock in a less-than-80-percent owned foreign corporation by a U.S. resident is U.S. source. A treaty may treat that income as foreign source. Under the bill, that income is subject to U.S. tax as foreign source income, but the U.S. resident may credit only foreign tax imposed on that income against the U.S. tax imposed on that income.

The bill provides, except as provided in regulations, that an election under section 338(h)(10) to treat a sale of stock in an affiliated corporation as a sale of assets does not treat that sale as a sale of assets for purposes of determining source in determining the seller's foreign tax credit limitation. Instead, for these purposes, the gain is treated as a gain from the sale of stock.

It is anticipated that any regulations prescribed under the general regulatory authority provided under section 338 will limit the applicability of the scope of section 338 so that that section will not affect inappropriately the determination of source and of a taxpayer's foreign tax credit limitation. Moreover, to the extent that regulations prescribed under section 336(e) extend the principles of section 338 to a sale of stock in a foreign corporation, it is anticipated that those regulations will not affect inappropriately the determination of source and of a taxpayer's foreign tax credit limitation.

The bill's modification to section 338(h)(10) is effective for transactions occurring after the date of the bill's introduction.

2. Special rules for exemption from U.S. tax on U.S. source transportation income (sec. 112(e) of the bill, sec. 1212 of the Reform Act, and secs. 872 and 883 of the Code)

Present Law

The Code's reciprocal exemption provisions sometimes exempt foreign persons from U.S. tax on U.S. source transportation income. Prior to the Act, the reciprocal exemption provisions exempted foreign persons from U.S. tax on earnings derived from the operation of ships (or aircraft) documented under the laws of a foreign country if that country exempted U.S. citizens and domestic corporations from its tax. The Act modified these provisions to provide the exemption from U.S. tax only to alien individuals who are residents of, and foreign corporations organized in, a foreign country which grants U.S. citizens and domestic corporations an equivalent exemption.

A foreign corporation, in addition to having to be organized in a country that grants U.S. persons an equivalent exemption, must also satisfy a residence-based requirement to obtain U.S. tax exemption. The residence-based requirement requires that ultimate individual owners of more than 50 percent of the foreign corporation be residents of a foreign country that grants U.S. citizens and domestic corporations an equivalent exemption. Thus, it is not enough for the foreign corporation to be organized in a foreign country which grants U.S. citizens and domestic corporations an equivalent exemption: individuals ultimately owning most of its stock must reside in such a country as well. Ultimate individual ownership is determined by treating stock owned directly or indirectly by or for any entity (for example, a corporation, partnership, or trust) as being actually owned by the stockholder (or partner, grantor, or beneficiary, as the case may be) of that entity and by further attributing that ownership to its owners if necessary to reach individual owners.

The residence-based requirement does not apply to any foreign corporation organized in a foreign country that exempts U.S. persons from its tax if the stock of the corporation is primarily and regularly traded on an established securities market in that foreign country. This publicly traded exception also covers a foreign corporation that is wholly owned by a second corporation organized in the same country as the first foreign corporation if the stock of the second foreign corporation is primarily and regularly traded on an established securities market in that country.

Explanation of Provision

The bill modifies the reciprocal exemption provisions so that they operate independently with respect to nonresident alien individuals and foreign corporations. Thus, for a nonresident alien individual to be exempt from U.S. tax, his or her country of residence must exempt only U.S. citizens from its tax. Similarly, for a foreign corporation to be exempt from U.S. tax, its country of organization must exempt only domestic corporations from that country's tax.

The bill extends the publicly-traded exception to the residence-based requirement to certain foreign corporations that are wholly owned subsidiaries of third-country parent corporations. This extension applies to a parent corporation that is organized in a country that exempts domestic corporations from its tax if the parent corporation's stock is primarily and regularly traded on an established securities market in its country of organization. Thus, if both the parent corporation and its wholly-owned subsidiary are organized in foreign countries that grant equivalent exemptions to U.S. corporations, and the stock of the former is primarily and regularly traded in its country of organization, then the subsidiary is exempt from U.S. tax regardless of whether more than 50 percent of its stock is owned by local residents.

3. Limitations on special treatment of 80/20 corporations (sec. 112(f) of the bill, sec. 1214 of the Reform Act, and secs. 861 and 2105 of the Code)

Present Law

Prior to the Act, a U.S. corporation's dividend and interest payments were foreign source and not subject to U.S. withholding tax when at least 80 percent of the U.S. corporation's income over the prior three years was from foreign sources (commonly referred to as an 80/20 company). The Act repealed prior law as it applied to dividends paid by an 80/20 company (other than dividends paid by a possessions corporation) and treats dividends paid by U.S. corporations as U.S. source. Dividends received by foreign persons from U.S. corporations, though treated as U.S. source, receive look-through treatment for U.S. withholding tax purposes when the corporation satisfies an active foreign business requirement. In such a case, the amount of the withholding tax exemption is based on the source of the income earned by the U.S. corporation. With respect to interest payments by a U.S. corporation, the Act generally treats the interest as U.S. source unless the corporation satisfies the active foreign business requirement. If the active foreign business requirement is met, the Act treats interest paid by a U.S. corporation as foreign source if the interest is paid to unrelated parties and as having a prorated source based on the source of the payor's income if the interest is paid to related parties.

The active foreign business requirement is satisfied if at least 80 percent of the U.S. corporation's gross income for the 3-year period preceding the year of the payment is derived from foreign sources and is attributable to the active conduct of a trade or business in one or more foreign jurisdictions (or U.S. possessions).

The 80-percent active foreign business requirement may be met by the U.S. corporation alone or, instead, may be met by a group including domestic or foreign subsidiaries in which the U.S. corporation owns a controlling interest. It is intended that at least a 50-percent ownership interest be required for a subsidiary's business to be attributed to a U.S. shareholder. In allowing attribution of a subsidiary's active foreign business to a controlling corporate shareholder, the character (i.e., active foreign business income) of the subsidiary's gross income is intended to be attributed to the corporate shareholder only on the actual inclusion of income from the subsidiary, for example, dividends, interest, rents, or royalties, and for the purpose of determining the percentage of dividends paid by the shareholder that are subject to U.S. withholding tax. Thus, for example, dividends received by a corporate shareholder from controlled U.S. subsidiaries, though treated as U.S. source in the hands of the corporate shareholder, are to be characterized as active foreign business income for the purpose of this look-through rule in the same proportion that the controlled subsidiaries' active foreign business income bears to their total income. With respect to other items of income received from controlled subsidiaries, those amounts are to be characterized as active foreign business income to the extent they are allocated against active foreign business income of the payor.

Prior to the Act, certain income paid by U.S. persons to foreign persons was effectively exempted from U.S. withholding tax because the income was treated as foreign source income. Under the Act, the income is treated as U.S. source, but the exemption from U.S. withholding tax is made explicit. The interest affected includes interest on deposits with persons carrying on the banking business, interest on deposits or withdrawable accounts with a Federal or State chartered savings institution as long as such interest is a deductible expense to the savings institution under section 591, and interest on amounts held by an insurance company under an agreement to pay interest thereon, but, in each case, only if such interest is not effectively connected with the conduct of a trade or business within the United States by the recipient of the interest. The Act also made an explicit exemption from U.S. withholding tax for income derived by a foreign central bank of issue from bankers' acceptances. By treating the interest on deposits as U.S. source, it is not intended that the principal amounts which generate the income be includible in a foreign person's estate.

Explanation of Provision

The bill clarifies that, for purposes of attributing a lower-tier corporation's active foreign business income to an upper-tier U.S. corporation, the upper-tier corporation must own directly or indirectly at least 50 percent of both the voting power and value of the stock of the lower-tier corporation.

The bill clarifies that the change in source for certain interest on deposits does not change its treatment for estate tax purposes. Thus, for example, bank deposits the interest on which is not effectively connected with a U.S. trade or business, though such interest is treated as U.S. source income, are not treated as property within the United States.

Further, the bill clarifies that the Act's provisions are generally effective for payments made in taxable years of the payor beginning after December 31, 1986.

4. Rules for allocation of interest, etc., to foreign source income (sec. 112(g) of the bill, sec. 1215 of the Reform Act, and 864(e) of the Code)

Present Law

Basis of stock of nonaffiliated 10-percent owned corporation

When the tax book value method of expense apportionment is used, the Act provides a new rule to allocate and apportion expenses on the basis of assets when the asset is stock in one of certain corporations. If a 10-percent or more owned corporation is not included in the group treated as one taxpayer, then, in general, the adjusted basis of the stock owned in such corporation in the hands of a U.S. shareholder is increased by the amount of the earnings and profits of the corporation attributable to that stock and accumulated during the period the taxpayer held it. Earnings and profits are not limited to those accumulated in post-enactment years. (In general, two kinds of 10-percent owned corporations are not included in the one-taxpayer group: foreign corporations, and U.S. corporations that are more than 10- but less than 80-percent owned.) In the case of a deficit in earnings and profits of the corporation that arose during the period when the U.S. shareholder held the stock, that deficit reduces the adjusted basis of the asset in the hands of the shareholder. In that case, however, the deficit cannot reduce the adjusted basis of the asset below zero.

Under prior law and under the Act, subpart F inclusions increase stock basis in but do not decrease earnings and profits of a controlled foreign corporation (secs. 961 and 959). Congress did not intend that the addition of such amounts to stock basis by virtue of a subpart F inclusion (or another inclusion with an equivalent effect on basis) result in double counting.

Allocation of expenses to deductible dividends

The Act provides that for purposes of allocating or apportioning any deductible expense, any tax-exempt asset (and any income from such an asset) shall not be taken into account. A similar rule applies in the case of any dividend from a U.S. corporation that is eligible under section 243 for the 80-percent dividends received deduction (but not in the case of a dividend from a U.S. corporation that is eligible for the 100-percent dividends received deduction) and in the case of any dividend from a foreign corporation a fraction of which (that reflects its U.S. earnings) is eligible under section 245(a) for an 80-percent dividends received deduction.

Treatment of bank holding companies and banks

While the Act generally requires an affiliated group to be treated as if all members of the group were one taxpayer for purposes of allocating and apportioning interest expense, that general rule does not apply to any financial institution (described in section 581 or 591) if the business of the financial institution is predominantly with persons other than related persons or their customers, and if the financial institution is required by State or Federal law to be operated separately from any other entity which is not a financial institution. A bank to which this exception applies is not treated as a member of the group for applying the Act's general one-taxpayer rule for interest expense allocation and apportionment to other members of the group; instead, that bank and all other banks in the group are to be treated as one taxpayer (rather than each bank being treated as a separate taxpayer for this purpose).

Although treated separately from other group members for interest expense allocation, banks were to be treated as part of the overall group that the Act treats as one taxpayer for expenses other than interest. The Act does not make this distinction.

Direct allocation of interest expense when deduction is denied

The Act provides that the Secretary is to prescribe such regulations as may be necessary or appropriate to carry out the purposes of this section, including regulations providing for direct allocation of interest expense incurred to carry out an integrated financial transaction to any interest (or interest-type income) derived from such transaction.

In certain cases, the dividends received deduction is reduced in cases where portfolio stock is debt financed (Code sec. 246A). In addition, a life insurance company is allowed a dividends received deduction for its share of dividends received, but this deduction is not allowed for the policyholders' share of dividends received. Further, the reserve deduction and other deductible payments to policyholders of a life insurance company are reduced by the policyholders' share of tax exempt interest. Moreover, in the case of a property and casualty insurance company, 15 percent of the sum of tax exempt interest and the deductible portion of dividends received reduces the deduction for losses incurred (section 832(b)(4)).

Scope of expense allocation rules

For purposes of subchapter N of chapter 1 of the Code (secs. 861-999), except as provided in regulations, the Act provides a series of rules governing expense allocation and apportionment. The intent of the grant of regulatory authority was to allow regulations to identify provisions of this subchapter to which the new rules would not apply. The Act's rules literally apply for the determination of taxable income from sources outside the United States. With one exception, however, these rules were intended to apply for all determinations under subchapter N of chapter 1, whatever the source (U.S. or foreign) of the income against which expenses are allocated. The exception relates to the possessions tax credit: Congress did not intend that new Code section 864(e)(1) apply for purposes of computations under section 936(h).

Transition rules

The Act provides a number of transition rules designed to phase in the application of the new expense allocation rules insofar as they relate to interest expenses.

Explanation of Provisions

Basis of stock of nonaffiliated 10-percent owned corporations

The bill clarifies the Act's rule governing the allocation and apportionment of expenses when the tax book value method is used and the asset at issue is stock in one of certain corporations. The adjusted basis of any stock in a nonaffiliated 10-percent owned corporation is increased by the amount of earnings and profits of that corporation attributable to that stock and accumulated during the period the taxpayer held the stock, or reduced, but not below zero, by any deficits in earnings and profits in that corporation attributable to that stock for that period. For this purpose, a "nonaffiliated 10-percent owned corporation" is one that is not included in the taxpayer's affiliated group, and in which members of the affiliated group own 10 percent or more of the voting power. The bill makes it clear that the adjustment to asset value on a look-through basis is also applied to stock of foreign corporations that is not directly held by U.S. taxpayers but that is indirectly 10-percent owned by U.S. taxpayers. Stock owned directly or indirectly by a corporation, partnership, or trust is treated as being owned proportionately by its shareholders, partners or beneficiaries. When a taxpayer is treated under this look-through rule as owning stock in a lower tier corporation, the adjustment to the basis of the upper-tier corporation in which the taxpayer actually owns stock is to include an adjustment for the amount of the earnings and profits (or deficit in earnings and profits) of the lower-tier corporation which were attributable to the stock the taxpayer is treated as owning and to the period during which the taxpayer is treated as owning that stock.

The bill provides that proper adjustment is to be made to the earnings and profits of any corporation to take into account any earnings and profits included in gross income under the subpart F current inclusion rules (or under any other provision) that are reflected in the adjusted basis of the stock. Thus, a subpart F inclusion, which increases stock basis but does not decrease earnings and profits of a controlled foreign corporation, is not to result in double counting.

Allocation of expenses to deductible dividends

The bill makes it clear that to the extent any dividend benefits from the dividends received deduction under section 243 (allowing an 80-percent dividends received deduction for certain dividends from U.S. corporations) or 245(a) (allowing an 80-percent dividends received deduction for the U.S. source portion of certain dividends from foreign corporations), that portion of the dividend is treated as tax exempt income for the purpose of the Act's expense allocation rules and that portion of the related asset is treated as a tax exempt asset.

Treatment of bank holding companies and banks

The bill provides that, to the extent provided in regulations, a bank holding company (within the meaning of section 2(a) of the Bank Holding Company Act of 1956), and any subsidiary of a bank holding company predominantly engaged in the active conduct of a banking, financing, or similar business, shall be treated as a financial institution for the exception that applies in certain cases to financial institutions described in section 581 or 591. The bill also makes it clear that any financial institution that is excluded from the general one-taxpayer group and is included in a one-taxpayer group covering financial institutions is not so treated for purposes of expenses other than interest. That is, financial institutions and all other affiliated entities are treated as one taxpayer under the Act for expenses other than interest.

Direct allocation of interest expense when deduction is denied

The bill provides that the Secretary is to prescribe regulations for direct allocation of interest expense in the case of indebtedness resulting in a disallowance under section 246A, which reduces the dividends received deduction in cases where portfolio stock is debt financed. Thus, to the extent that an interest deduction reduces the amount of the dividends received deduction, the interest expense generating the loss of the dividends received deduction is to be treated as directly allocable to the income resulting from the loss of the dividends received deduction.

Under the bill, the Secretary is also to prescribe regulations providing that, in the case of an life insurance company, the Act's rule requiring that tax-exempt assets and income therefrom be disregarded will not apply to the policyholders' share of any tax-exempt asset or income from such an asset. That is, the policyholders' share of assets that produce tax-exempt income will attract expenses notwithstanding their tax-exempt character. The same treatment applies to tax-exempt assets of property and casualty insurance companies, to the extent that the income from such assets reduces that company's loss deduction (under section 832(b)(4)).

In general, similar treatment is to apply with respect to the policyholder's share of stock that insurance companies hold to the extent that dividends it pays would be eligible for the 80-percent dividends received deduction. Thus, that stock will attract expenses notwithstanding the deduction for the dividends it would pay.

Scope of expense allocation rules

The bill provides that new Code section 864(e) (relating to expense allocation) shall not apply for purposes of any provision of subchapter N of chapter 1 of the Code (secs. 861-999) to the extent the Secretary determines under regulations that the application of this subsection for such purposes would not be appropriate. In a conforming amendment, the bill deletes the provision for exceptions to new Code section 864(e) in the introductory language to that subsection.

With one exception, the bill makes it clear that these rules apply for all determinations under subchapter N of chapter 1, whatever the source of the income against which expenses are allocated. The exception relates to the possessions tax credit: Code section 936(h) is to apply as if new Code section 864(e)(1) had not been enacted.

Transition rules

The bill clarifies the operation of the Act's transition rules.

One set of the bill's provisions clarifies the Act's phase-in of the Act's new rules governing interest expense allocation generally. (This set of the bill's provisions does not affect the Act's phase-in of the one-taxpayer rule of new Code sec. 864(e)(1), which is described below.) These clarifications, the bill's "general" phase-in provisions, apply to the aggregate amount of indebtedness of the taxpayer outstanding on November 16, 1985. In the case of the first three taxable years of the taxpayer beginning after December 31, 1986, the Act's amendments relating to interest expense allocation (other than the one-taxpayer rule of new Code sec. 864(e)(1)) do not apply to interest expenses paid or accrued by the taxpayer during the taxable year with respect to an aggregate amount of indebtedness which does not exceed the general phase-in amount. Except for certain reductions in indebtedness, the consequences of which are described below, the general phase-in amount is the applicable percentage of the taxpayer's debt outstanding on November 16, 1985. In the case of the first taxable year, the applicable percentage is 75; in the case of the second taxable year, the applicable percentage is 50; in the case of the third taxable year, the applicable percentage is 25.

The general phase-in amount eligible for relief for any period, however, is not to exceed the lowest amount of indebtedness of the taxpayer outstanding as of the close of any preceding month beginning after November 16, 1985. To the extent provided in regulations, the average amount of indebtedness outstanding during any month is to be used in lieu of the amount outstanding as of the close of such month for this purpose. This grant of regulatory authority is designed to allow the Internal Revenue Service to disallow transition relief to taxpayers whose month-end debt levels are not representative of their monthly debt levels generally. Reductions in debt as of a month's end are not to reduce phase-in relief for prior months, however. For example, if a calendar year taxpayer's outstanding debt is $100 on November 16, 1985 and at all times thereafter until December 1, 1987, at which time it pays off all its debt, the taxpayer is entitled to general phase-in treatment for interest on $75 during the first 11 months of 1987.

In addition, the bill's "special" phase-in rules clarify the Act's provisions that phase in the Act's one-taxpayer rule (new Code sec. 864(e)(1)). In the case of the taxpayer's first five taxable years beginning after December 31, 1986, the Code's new one-taxpayer rule (Code sec. 864(e)(1)) is not to apply to interest expenses paid or accrued by the taxpayer during the taxable year with respect to an aggregate amount of indebtedness that does not exceed the special phase-in amount. The special phase-in amount is the sum of three separate amounts: the general phase-in amount, described above, the five-year phase-in amount, and the four-year phase-in amount.

The five-year phase-in amount is the lesser of two amounts. The first amount is an applicable percentage of the "5-year base." The 5-year base is the the excess (if any) of the amount of a taxpayer's outstanding indebtedness on May 29, 1985, over the amount of the taxpayer's outstanding indebtedness as of the close of December 31, 1983. For this purpose, however, the 5-year base cannot exceed the aggregate amount of indebtedness of the taxpayer outstanding on November 16, 1985. The applicable percentage, in each year, is the excess of the percentage granted relief under the Act's 5-year phase-in over the percentage granted relief under the Act's general (3-year) phase-in. In the case of the first taxable year beginning after December 31, 1986, the applicable percentage is 8-1/3 (83-1/3 - 75); in the case of the second taxable year, the applicable percentage is 16-2/3 (66-2/3 – 50); in the case of the third taxable year, the applicable percentage is 25 (50 – 25); in the case of the fourth taxable year, the applicable percentage is 33-1/3; and in the case of the fifth taxable year, the applicable percentage is 16-2/3.

The 5-year phase-in amount cannot exceed a second amount. That second amount, which is in the nature of a limitation, caps the 5-year phase-in amount in cases where reductions of indebtedness ("paydowns") reduce the taxpayer's debt below the amount that would have been eligible for 5-year relief had no paydown occurred. More specifically, the second amount is the 5-year base, reduced (but not below zero) by paydowns of debt, and then multiplied by a percentage. The paydowns that reduce the 5 year base for this purpose are defined as the excess of the taxpayer's November 16, 1985, debt over the lowest amount of indebtedness of the taxpayer outstanding as of the close of any preceding month beginning after November 16, 1985 (or to the extent provided in regulations, as under the general phase-in, the average amount of indebtedness outstanding during any such month).

To compute this second amount, the (possibly reduced) 5-year base is multiplied by a fraction the numerator of which is the applicable 5-year percentage (the excess of the 5-year percentage under present law over the 3-year percentage), and the denominator of which is the sum of the applicable percentage under the general (3-year) rule and the applicable percentage under the 5-year rule. This second amount limits the 5-year base only in cases where paydowns reduce the amount of the 5-year base below the amount of relief that would be granted if no paydown had occurred. In the case of the first taxable year beginning after December 31, 1986, this percentage is 10, *i.e.*, 8-1/3 divided by the sum of 8-1/3 and 75; in the case of the second taxable year, this percentage is 25, *i.e.*, 16-2/3 divided by the sum of 50 and 16-2/3; in the case of the third taxable year, this percentage is 50, *i.e.*, 25 divided by 50; in the case of the fourth taxable year, this percentage is 100, *i.e.*, 33-1/3 divided by 33-1/3; and in the case of the fifth taxable year, this percentage is 100, *i.e.*, 16-2/3 divided by 16-2/3.

This second amount preserves the full 5-year benefit in cases where the taxpayer's lowest debt is equal to or greater than the product of the 5-year base (unreduced by paydowns) and Act's 5-year percentage. (The Act's 5-year percentage is restructured under the bill as the sum of two applicable percentages: the applicable percentage for the purpose of the general (3-year) rule and the add-on applicable percentage for the purpose of the 5-year rule.) If paydowns have reduced outstanding debt below the amounts that would have obtained full benefit under the 5-year rule had no paydowns occurred, this second amount reduces the 5-year benefit on a linear basis.

The 4-year phase-in amount is the lesser of two amounts. These amounts parallel the principles set forth above in connection with the 5-year amounts. The first amount is the applicable percentage of the "4-year base." The 4-year base is the the excess (if any) of the amount taxpayer's outstanding indebtedness on December 31, 1983, over the amount of the taxpayer's outstanding indebtedness as of the close of December 31, 1982. For this purpose, however, the 4-year base cannot exceed the excess of the aggregate amount of indebtedness of the taxpayer outstanding on November 16, 1985 over the 5-year base. The applicable percentage, in each year, is the excess of the percentage granted relief under the Act's 4-year phase-in over the percentage granted relief under the Act's general (3-year) phase-in. In the case of the first taxable year beginning after December 31, 1986, the applicable percentage is 5 (80 - 75); in the case of the second taxable year, the applicable percentage is 10 (60 – 50); in the case of the third taxable year, the applicable percentage is 15 (40 - 25); and in the case of the fourth taxable year, the applicable percentage is 20.

The 4-year phase-in amount cannot exceed a second amount. That second amount is intended to reduce the 4-year phase-in amount to the extent that paydowns reduce the taxpayer's debt below the amount that would be eligible for 4-year relief had no paydown occurred. More specifically, the second amount is the 4-year base, reduced (but not below zero) by certain paydowns of debt, multiplied by a percentage. The paydowns that reduce the 4-year base for this purpose are generally defined as the excess of the taxpayer's November 16, 1985, debt, over the lowest amount of indebtedness of the taxpayer outstanding as of the close of any preceding month beginning after November 16, 1985 (or to the extent provided in regulations, as under the general phase-in, the average amount of indebtedness outstanding during any such month). This paydown amount for 4-year purposes is reduced, but not below zero, by the amount of the 5-year base.

For purposes of this second amount, the (possibly reduced) 4-year base is multiplied by a fraction the numerator of which is the percentage added to general relief under the 4-year rule and the denominator of which is the percentage granted relief after the application of both the 4-year rule and the general (3-year) relief. In the case of the first taxable year beginning after December 31, 1986, this percentage is 6.25, *i.e.*, 5 divided by (5 + 75); in the case of the second taxable year, this percentage is 16-2/3, *i.e.*, 10 divided by 60; in the case of the third taxable year, this percentage is 37.50, *i.e.*, 15 divided by 40; and in the case of the fourth taxable year, this percentage is 100, *i.e.*, 20 divided by 20.

The bill provides that, to the extent possible, the general and special phase-in rules are to apply to the same amount of indebtedness.

The bill clarifies that amounts eligible for relief under the Act's phase-in rules are determined on the basis of indebtedness rather than interest expense. The bill is not intended to require that specific interest expense be traced to specific indebtedness.

The following examples involve the application of the special phase-in rule for one-taxpayer treatment and the general phase-in rule for the Act's other interest expense allocation rules.

Example 1

A U.S. parent company, a calendar year taxpayer, had outstanding third party interest-bearing debt of $50 from 1980 until December 31, 1982. On July 1, 1983, the taxpayer's third party interest-bearing debt increased to $70. On July 1, 1984, the taxpayer's third party interest-bearing debt increased to $100. All this debt bore and bears annual interest at the same interest rate.

The U.S. parent corporation's third party debt is $100 on November 16, 1985, and at all relevant times thereafter.

The general transition rule prevents application of any of the Act's interest expense allocation rules (other than the one-taxpayer rule of Code sec. 864(e)(1)) to interest on 75 percent of $100, the November 16, 1985 amount. That is, the new rules (other than the one-taxpayer rule of Code sec. 864(e)(1), discussed below) cannot apply to interest on $75 of debt. The bill's limitation on the general phase-in amount does not affect this result because the taxpayer's debt level has not dipped below the amount otherwise eligible for general phase-in treatment, i.e., $75.

The special phase-in rule, which governs the application of the one-taxpayer rule of Code sec. 864(e)(1), operates as follows. The special phase-in amount, that is, the amount eligible for special phase-in treatment is the sum of the general phase-in amount (determined above to be $75) and the 5- and 4-year amounts.

The 5-year phase-in amount is the lesser of two amounts. The first amount is the applicable percentage of the "5-year base." The 5-year base is $30, the excess of $100, the amount of the taxpayer's outstanding indebtedness on May 29, 1985, over $70, the amount of the taxpayer's outstanding indebtedness as of the close of December 31, 1983. The applicable percentage, in the first taxable year beginning after December 31, 1986, is 8-1/3. Thus, the first amount is $2.50, that is, 8-1/3 percent of $30.

The 5-year phase-in amount cannot exceed a second amount. In the case of the first taxable year beginning after December 31, 1986, that second amount is the 5-year base, $30, unaffected here by paydowns of debt since none have occurred, and then multiplied by 10 percent, *i.e.*, 8-1/3 divided by the sum of 8-1/3 and 75. Thus, the second amount is $3 ($30 multiplied by 10 percent).

In this case, the 5-year amount is thus $2.50, the lesser of $2.50 and $3.

The 4-year phase-in amount is the lesser of two amounts. The first amount is the applicable percentage of the "4-year base." The 4-year base is $20, the excess of $70, the amount of the taxpayer's outstanding indebtedness on December 31, 1983, over $50, the amount of the taxpayer's outstanding indebtedness as of the close of December 31, 1982. The applicable percentage, in the first taxable year beginning after December 31, 1986, is 5. Thus, the first amount is $1, that is, 5 percent of $20.

The 4-year phase-in amount cannot exceed a second amount. In the case of the first taxable year beginning after December 31, 1986, that second amount is the 4-year base, $20, unaffected here by paydowns of debt since none have occurred, and then multiplied by 6.25 percent, *i.e.*, 5 divided by the sum of 5 and 75. Thus, the second amount is $1.25 ($20 multiplied by 6.25 percent).

In this case, the 4-year amount is thus $1, the lesser of $1 and $1.25.

Thus, in this example, the amount of debt qualifying for one-taxpayer treatment is $78.50, which is the sum of $75, the general phase-in amount; $2.50, the 5-year phase-in amount; and $1, the 4-year phase-in amount. In this example, then, since the indebtedness to which the general phase-in applies is to be, to the extent possible, the same indebtedness to which the special phase-in applies, interest expense on $75 of debt is to be allocated under old law, interest expense on $3.50 of debt is to be allocated without use of the one-taxpayer rule but with use of the Act's other rules governing interest allocation, and interest on $21.50 is to be apportioned under the Act's new rules.

Example 2

Assume the same facts as in the example above, except that the U.S. parent corporation's third party debt is $100 on November 16, 1985, and until January 1, 1987, at which time it pays its debt down to $85. Its debt remains $85 at all relevant times thereafter.

Again, the general transition rule prevents application of any of the Act's interest expense allocation rules (other than the one-taxpayer rule of Code sec. 864(e)(1)) to interest on $75. That is, the new rules (other than the one-taxpayer rule of Code sec. 864(e)(1), discussed below) cannot apply to interest on $75 of debt. The bill's limitation on the general phase-in amount does not affect this result because the taxpayer's lowest debt level, $85, has not dipped below the amount otherwise eligible for general phase-in treatment, i.e., $75.

The special phase-in rule, which governs the application of the one-taxpayer rule of Code sec. 864(e)(1), operates as follows. The amount eligible for special phase-in treatment is the sum of the general phase-in amount (again determined above to be $75) and the 5- and 4-year amounts.

The 5-year phase-in amount is the lesser of two amounts. The first amount is again $2.50, that is, 8-1/3 percent of $30.

The 5-year phase-in amount cannot exceed a second amount. In the case of the first taxable year beginning after December 31, 1986, that second amount is the 5-year base, $30, reduced by the $15 paydown of debt (representing the difference between the November 16, 1985, amount and the $85 lowest monthly amount) to $15 and then multiplied by 10 percent. Thus, the second amount is $1.50 ($15 multiplied by 10 percent).

In this case, the 5-year amount is thus $1.50, the lesser of $2.50 and $1.50.

The 4-year phase-in amount is again the lesser of two amounts. The first amount again is $1, that is, 5 percent of $20.

The 4-year phase-in amount cannot exceed a second amount. In the case of the first taxable year beginning after December 31, 1986, that second amount is the 4-year base, $20, subject to reduction on account of the paydown of debt, multiplied by 6.25 percent. There is no reduction on account of paydowns in this example, because the $15 paydown for 4-year purposes is reduced, but not below zero, by the $30 amount of the 5-year base. Thus, the second amount is again $1.25 ($20 multiplied by 6.25 percent).

In this case, the 4-year amount is thus $1, the lesser of $1 and $1.25.

Thus, in this example, the amount of debt qualifying for one-taxpayer treatment is $77.50, which is the sum of $75, the general phase-in amount; $1.50, the 5-year phase-in amount; and $1, the 4-year phase-in amount. In this example, then, since the indebtedness to which the general phase-in applies is to be, to the extent possible, the same indebtedness to which the special phase-in applies, interest expense on $75 of debt is to be allocated under old law, interest expense on $2.50 of debt is to be allocated without use of the one-taxpayer rule but with use of the Act's other rules governing interest allocation, and interest on $22.50 is to be apportioned under the Act's new rules.

Example 3

A third example assumes examines the third taxable year beginning after 1986, the calendar year 1989. In this example, the facts are the same as in the first two examples, except that the taxpayer paid its debt down to $80 on January 1, 1989. Its debt remains at $80 throughout 1989.

The general transition rule prevents application of any of the Act's interest expense allocation rules (other than the one-taxpayer rule of Code sec. 864(e)(1)) to 25 percent of $100, the November 16, 1985 amount. That is, the new rules (other than the one-taxpayer rule of Code sec. 864(e)(1), discussed below) cannot apply to interest on $25 of debt. The bill's limitation on the general phase-in amount does not affect this result because the taxpayer's debt level has not dipped below $25.

The special phase-in rule, which governs the application of the one-taxpayer rule of Code sec. 864(e)(1), operates as follows. The amount eligible for special phase-in treatment is the sum of the general phase-in amount (determined above to be $25) and the 5- and 4-year amounts.

The 5-year phase-in amount is the lesser of two amounts. The first amount is the applicable percentage (25) of the 5-year base ($30). Thus, the first amount is $7.50, that is, 25 percent of $30.

The 5-year phase-in amount cannot exceed a second amount. In the case of the third taxable year beginning after December 31, 1986, that second amount is $5 (the 5-year base, $30, reduced by the $20 paydown) multiplied by 50 percent. Thus, the second amount is $5 ($10 multiplied by 50 percent).

In this case, the 5-year amount is thus $5, the lesser of $7.50 and $5.

The 4-year phase-in amount is the lesser of two amounts. The first amount is the applicable percentage for the third taxable year beginning after 1986 of the 4-year base ($20). The applicable percentage, in the third taxable year beginning after December 31, 1986, is 15. Thus, the first amount is $3, that is, 15 percent of $20.

The 4-year phase-in amount cannot exceed a second amount. In the case of the third taxable year beginning after December 31, 1986, that second amount is the 4-year base, $20, subject to reduction on account of the paydown of debt, multiplied by 37.5 percent. There is no reduction on account of paydowns in this example, because the $20 paydown for 4-year purposes is reduced, but not below zero, by the $30 amount of the 5-year base. Thus, the second amount is $7.50 ($20 multiplied by 37.5 percent).

In this case, the 4-year amount is thus $3, the lesser of $3 and $7.50.

Thus, in this example, the amount of debt qualifying for one-taxpayer treatment is $33, which is the sum of $25, the general phase-in amount; $5, the 5-year phase-in amount; and $3, the 4-year phase-in amount. In this example, then, since the indebtedness to which the general phase-in applies is to be, to the extent possible, the same indebtedness to which the special phase-in applies, interest expense on $25 of debt is to be allocated under old law, interest expense on $8 of debt is to be allocated without use of the one-taxpayer rule but with use of the Act's other rules governing interest allocation, and interest on $67 is to be apportioned under the Act's new rules.

The bill clarifies that for transition rule purposes, all members of an affiliated group of corporations are to be treated as one corporation. Thus, the bill makes it clear that debt of all members is to be aggregated in determining if a paydown that reduces phase-in benefits has occurred. Similarly, the bill makes it clear that interest on interaffiliate debt is not eligible for transition relief.

C. U.S. Taxation of Income Earned Through Foreign Corporations (sec. 112(h)-(k) of the bill, secs. 1023, 1221, and 1224-1226 of the Reform Act, and secs. 245, 246A, 552, 861, 881, 901, and 951-955 of the Code)

1. Captive insurance companies

Present Law

Election to treat related person insurance income as effectively connected with a U.S. business

Under subpart F of the Code, certain types of income of U.S.-controlled foreign corporations are included currently in shareholder income and taxed by the United States regardless of whether the income is actually distributed currently to shareholders. A taxpayer is generally subject to income inclusion under subpart F only if the taxpayer is a "U.S. shareholder" in a "controlled foreign corporation." Since the enactment of the subpart F rules in 1962, the term "U.S. shareholder" has generally been limited to those U.S. persons owning (directly, indirectly, or by attribution) 10 percent or more of a foreign corporation's combined voting power. The term "controlled foreign corporation" has generally been limited to those foreign corporations more than half of the stock of which is owned by U.S. shareholders (under the Act, more than half by vote or by value).

The Act introduced new subpart F rules for taxing the income of so-called captive foreign insurance companies. Under the new rules, related person insurance income of these companies is currently taxable to an expanded category of U.S. persons. The statute achieves this result first by treating as a "U.S. shareholder" any U.S. person who owns directly or indirectly *any* stock in a foreign corporation, whether or not it meets the 10 percent threshold; and second by lowering the U.S. shareholder ownership threshold for controlled foreign corporation status to 25 percent or more. These modifications apply only for purposes of taking into account related person insurance income under subpart F.

The Act provides three exceptions to the new subpart F rules for captive insurers. Under one of these exceptions, a foreign corporation may avoid the application of the new subpart F rules for captives by electing to treat related person insurance income that would not otherwise be taxed on a net basis (as effectively connected with a U.S. trade or business) as income that *is* effectively connected with a U.S. trade or business. The income deemed to be effectively connected under this election will be excluded from subpart F income.

Congress intended the election to be available only to those corporations which are controlled foreign corporations solely by virtue of the new rules for captive insurers. The Act provides that the election is to be made at such time and in such manner as the Secretary may prescribe. The election is effective in the year made and in all future years. The election is not effective if the electing corporation fails to meet such requirements as the Secretary shall prescribe to ensure that the tax imposed on its related person insurance income is paid.

To make the election, the foreign corporation must waive all U.S. income tax treaty benefits with respect to its related person insurance income. Treaty benefits with respect to the branch profits tax newly created by the Act are irrelevant to income with respect to which the election is properly made, however, because the Act excludes from the imposition of branch profits tax the earnings and profits attributable to income treated as effectively connected solely because of the election.

Amount of subpart F inclusion

When a controlled foreign corporation earns subpart F income, the United States generally taxes the corporation's U.S. shareholders currently on their pro rata share of the subpart F income. Related person insurance income (as defined by the Act) is a type of subpart F income.

In the case of a corporation that is a controlled foreign corporation for its entire taxable year, and a U.S. shareholder that owns the same proportion of stock in the corporation throughout the corporation's taxable year, the U.S. shareholder's pro rata share of subpart F income is the amount that would have been distributed with respect to the shareholder's stock if on the last day of the taxable year the controlled foreign corporation had distributed all of its subpart F income pro rata to all of its shareholders.

The pro rata share definition provides for adjustments where the corporation is a controlled foreign corporation for less than the entire year or where actual distributions are made with respect to stock the shareholder owns for less than the entire year. The latter adjustment, contained in section 951(a)(2)(B), reduces a U.S. shareholder's pro rata share by a fraction of the dividends distributed to any other person during the controlled foreign corporation's taxable year on stock owned by the U.S. shareholder at year-end. The fraction equals the proportion of the taxable year during which the U.S. shareholder did not own the stock.

Primary insureds

The Act defines related person insurance income as any insurance income attributable to a policy of insurance or reinsurance with respect to which the primary insured is either a U.S. shareholder (as defined above) in the foreign corporation receiving the income or a person related to such a shareholder.

It was Congress' intent that related person insurance income include income attributable to policies of reinsurance issued by a foreign corporation to its U.S. shareholders that previously insured the risks covered by such policies or to persons related to such shareholders that previously insured the risks covered by such policies. In addition, Congress gave the Secretary authority under the Act to prevent the avoidance of the captive insurance rules through cross insurance arrangements or otherwise.

The new subpart F rules for captive insurers do not apply if less than 20 percent of the stock of the corporation (by vote or by value of both stock and policies) is owned (directly or indirectly) by persons who are the primary insureds under any policies of insurance or reinsurance issued by the corporation, or by persons related to such primary insureds.

Gross insurance income

Under a de minimis exception to the new subpart F rules for captive insurers, these rules do not apply to income of a foreign corporation whose related person insurance income for the taxable year is less than 20 percent of its insurance income for the year. Congress intended that this computation be performed on a gross basis. Insurance income is defined for this purpose as it is generally for subpart F purposes under the Act, except that the exclusion of income attributable to same-country risks does not apply.

Definition of related person

The application of the new captive insurance rules turns on the distinction between persons who are and are not related to U.S. shareholders (within the meaning of section 954(d)(3) as amended by the Act). A person is related to a controlled foreign corporation if the person controls, is controlled by, or is under common control with the controlled foreign corporation.

Congress intended that related person insurance income include income attributable to officers' or directors' insurance where the U.S. shareholders of the foreign corporation receiving such income (or persons related to such shareholders) directly or indirectly pay the premiums and the insureds are officers or directors of the U.S. shareholders (or persons related to such shareholders).

Definition of related person insurance income

As stated above, the Act defines related person insurance income as a type of "insurance income." The Code provides special rules for computing tax haven insurance income. Section 953(b) states that for these purposes all items of income, expenses, losses, and deductions shall be properly allocated or apportioned under regulations prescribed by the Secretary. Section 953(b) also eliminates or limits the applicability of certain provisions of subchapter L of the Code ("Insurance Companies") for these purposes. Congress intended that these special rules for computing tax haven insurance income apply in computing related person insurance income.

Explanation of Provisions

Election to treat related person insurance income as effectively connected with a U.S. business

The bill supplements the Code provisions describing the election to treat related person insurance income as effectively connected with a U.S. trade or business in order to make it clear that the election is not available to a corporation that is a controlled foreign corporation without applying the special subpart F rules for captive insurance companies, or that was a controlled foreign corporation without regard to those rules for any pre-election taxable year beginning after 1986. The bill further provides that if a corporation is entitled to make the election in one year, but in a later year becomes a controlled foreign corporation as defined by the general subpart F rules, an election made for the earlier year shall not apply to any taxable year after the later year. Thus, the bill clarifies that the election is available only in situations where a foreign corporation and its shareholders are subject to subpart F treatment by virtue of the Act's special captive insurance rules, and not where subpart F treatment results from application of the rules that are generally applicable outside the captive insurance context.

The bill also provides that in making the election the foreign corporation must waive all benefits (other than benefits with respect to the branch profits and branch interest taxes newly imposed by the Act) under any treaties between the United States and any foreign country. Thus, for example, tax benefits claimed under a friendship, commerce, and navigation treaty would have to be waived by a foreign corporation making the election. However, the bill clarifies that treaty benefits with respect to the branch taxes need not be waived with respect to related person insurance income when that income is effectively connected without regard to the election.

Amount of subpart F inclusion

The bill provides a special definition of "pro rata share" for purposes only of taking into account related person insurance income. For these purposes, the special pro rata share definition is the lesser of (i) the amount which would be determined under the usual subpart F definition of pro rata share if only related person insurance income were taken into account, if stock owned by U.S. shareholders on the last day of the taxable year were the only stock in the foreign corporation, and if only distributions received by U.S. shareholders were taken into account under section 951(a)(2)(B); or (ii) the amount which would be determined under the usual subpart F definition of pro rata share if the entire earnings and profits of the corporation for the taxable year were subpart F income.

For example, assume that throughout the first taxable year of a foreign corporation ("C"), 50 percent of the stock of C is owned by U.S. persons and the rest by foreign persons unrelated to U.S. persons. C's only activity is insuring risks of its U.S. shareholders and its foreign shareholders. During the taxable year exactly 50 percent of the income of C is related person insurance income and the earnings and profits of C for the year are twice C's related person insurance income for the year. Assume that C has no U.S. tax liability, that C has no other subpart F income for the taxable year, and that it does not distribute any of its earnings or invest in U.S. property during the year.

Under the Act's new rules for captives, all U.S. persons that own stock in C are U.S. shareholders. Under the ordinary subpart F rules for computing their income inclusions, they would be treated as if C distributed to them half of its related person insurance income. This portion of C's related person insurance income would be taxed to the U.S. shareholders; the rest of C's related person insurance income would not be taxed currently by the United States.

Under the bill, by contrast, the U.S. shareholders are taxed currently on all of C's related person insurance income.

Thus, the effect of the bill's special pro rata share definition is to ensure that if related person insurance income of a controlled foreign corporation is at all currently taxable to U.S. shareholders under subpart F, then the full amount of the controlled foreign corporation's related person insurance income will be currently taxable, up to the U.S. shareholders' proportionate share of the controlled foreign corporation's earnings and profits. Partial ownership of the corporation by foreign persons will not reduce the portion of the corporation's related person insurance income that is currently taxable to the U.S. shareholders (assuming the controlled foreign corporation has sufficient earnings and profits). As used in the bill's special pro rata share definition, the term "U.S. shareholder" has the meaning that it has when taking into account related person insurance income: i.e., as modified by section 953(c)(1)(a) (which dispenses with the 10 percent threshold).

The bill further provides the Secretary with authority to modify the other rules of subpart F where necessary to permit an appropriate computation of pro rata share under the bill's special rule. For example, it may be necessary or appropriate for the Secretary to coordinate this rule with the general pro rata share definition where the controlled foreign corporation has other types of subpart F income; or regulations may be appropriate for determining how the various types of subpart F income are to be reduced to account for the earnings and profits limitation on subpart F income..

Primary insureds

The bill eliminates the word "primary" from the references to "primary insureds" in the definition of related person insurance income and in the exception from the special captive insurance rules for corporations less than 20 percent of whose owners are insureds or related to insureds. Thus the bill clarifies that these references are intended to cover policies of reinsurance issued to U.S. shareholders and related persons, regardless of whether the contracts being reinsured were issued to unrelated persons. The Secretary retains regulatory authority to extend related person insurance income treatment to income from reinsurance issued to unrelated parties, in those cases where doing so is necessary to prevent the avoidance of the captive insurer rules.

Gross insurance income

The bill clarifies that for purposes of applying the de minimis exception to the captive insurance rules, comparison of a foreign corporation's related person insurance income to its insurance income is made on a gross basis. Thus, the de minimis rule is applied without regard to the relative profitability of the foreign corporation's related person insurance income, on the one hand, and its total insurance income, on the other.

Definition of related person

The bill modifies the definition of related person for purposes of the captive insurance rules, making it clear that in the case of any insurance policy covering liability arising from services performed as a director, officer, or employee of a corporation or as a partner or employee of a partnership, the person performing the services and the entity for which the services are performed will be treated as related persons. (As discussed below, the bill also raises the control threshold for related person status generally from 50 percent to more than 50 percent.)

Definition of related person insurance income

The bill refines the definition of related person insurance income so that it specifically refers to insurance income as that term is defined in section 953(a), thus incorporating the special rules set forth in 953(b) for computing tax haven insurance income.

2. Insurance companies in general

Present Law

Fresh start for computing discounted unpaid losses

To take partial account of the time value of money, the Act amends subchapter L of the Code to provide for the discounting of the deduction for loss reserves of property and casualty insurance companies. Thus, the Act limits the deduction for unpaid losses to the amount of discounted unpaid losses (new sec. 846 of the Code).

In general, the new discounting provisions apply to taxable years beginning after December 31, 1986. A fresh start is provided with respect to undiscounted loss reserves applicable to the last taxable year beginning before January 1, 1987. Under this fresh start rule, the difference between the amount of undiscounted loss reserves and the discounted balances is not taken into income.

The Act provides that the fresh start adjustment is to be taken into account in full in the first taxable year to which the discounting provisions apply (generally, taxable years beginning in 1987) for purposes of calculating any adjustment to earnings and profits. The current earnings and profits of a controlled foreign corporation serve as a limitation on the amount of the corporation's subpart F income for the current taxable year.

Definition of United States risk

Section 861(a)(7) (unchanged by the Act) treats as U.S. source income amounts received as underwriting income derived from the insurance of U.S. risks as defined in section 953(a). Prior to the Act, section 953(a) defined the term "income derived from the insurance of U.S. risks" as income that would (subject to certain modifications described in section 953(b)) be taxed under subchapter L if the income were that of a domestic insurance company, and that is attributable to the reinsurance or the issuing of any insurance or annuity contract (1) in connection with property, activities, or the lives or health of individuals resident in the United States, or (2) under any arrangement where another corporation receives a substantially equal amount for covering such risks.

In connection with the Act's expansion of the subpart F tax haven insurance definition, extending current taxation to any income attributable to the issuing (or reinsuring) of any insurance or annuity contract in connection with risks in a country other than that in which the insurer is created or organized, the definition of U.S. risk was no longer relevant for section 953(a) purposes. Congress did not intend to alter the substance of the related source rule in section 861(a)(7).

Explanation of Provision

Fresh start for computing discounted unpaid losses

The bill provides that for purposes of computing the earnings and profits limitation on subpart F income, current earnings and profits are determined without regard to the increase in current earnings and profits under the discounting fresh start provision of the Act. Thus, the one-time increase in current earnings and profits of a controlled foreign corporation under the discounting fresh start provision will not result in any increase in subpart F income of that corporation.

Definition of United States risk

The bill reinstates for purposes of 861(a)(7) the pre-Act definition of income from U.S. risks. The bill treats as U.S. source income amounts received as underwriting income derived from the issuing (or reinsuring) of any insurance or annuity contract (1) in connection with property, activities, or the lives or health of individuals resident in the United States, or (2) under any arrangement where another corporation receives a substantially equal amount for covering such risks.

3. Withdrawals of qualified shipping reinvestments that pre-Act law excluded from subpart F income

Present Law

The Act repealed the rule that, under prior law, excluded from subpart F income foreign base company shipping income that was reinvested in foreign base company shipping operations. This change was not intended to modify the taxation of withdrawals (whether by disposition of assets, adjustments to basis, or otherwise) of previously excluded subpart F income from qualified shipping reinvestments. Under the Act, the withdrawal from qualified investment for a particular taxable year is measured by reference to the excess of qualified investments as of the close of the last taxable year beginning before 1987 over the qualified investments at the close of the subsequent taxable year.

Explanation of Provision

The bill makes it clear that withdrawals of previously excluded subpart F income from qualified shipping reinvestments are to be taxed only once. For any taxable year beginning after 1986, the amount of withdrawal from qualified shipping investments for that year is limited by the bill to the excess (if any) of (1) the amount of pre-1987 qualified investments then remaining after the decreases in qualified investments determined for prior taxable years beginning after 1986, over (2) qualified shipping investments at year-end. Under this rule, post-1986 investments that meet the definition of qualified investments in foreign base company shipping operations will delay the taxation of withdrawals until all such post-1986 investments are withdrawn.

4. Definition of related person

Present Law

Whether a controlled foreign corporation's income is subject to subpart F will depend in certain cases on whether the income is received from a related person. Generally, for example, dividends, interest, royalties, and rents are subpart F income. However, rents and royalties, for example, may be excluded from subpart F income if derived in the active conduct of a trade or business and received from a person other than a related person (sec. 954(c)(2)(A)). As another example, dividends and interest may be excluded if received from certain related persons organized under the laws of the same country as the controlled foreign corporation (sec. 954(c)(3)(A)(i)).

A related person is one which controls, is controlled by, or is under common control with the controlled foreign corporation. The Act amended the definition of control for this purpose. In the case of a corporation, control means the direct or indirect ownership of 50 percent or more of the total combined voting power of all classes of stock entitled to vote or of the total value of such corporation. In the case of a partnership, trust, or estate, control is defined as direct or indirect ownership of 50 percent or more of the total value of the beneficial interests in the entity.

Whether income is subject to the separate foreign tax credit limitation for passive income may also turn on whether it is received from a related person. The definition of the passive income basket is generally based on the definition of foreign personal holding income under subpart F, which in turn uses the concept of "related person" to provide certain exceptions from foreign personal holding company income, such as rents and royalties derived in an active business, and certain same-country dividends and interest. In addition, if a corporation is a controlled foreign corporation, payments that it makes to its U.S. shareholders may be characterized for purposes of the foreign tax credit baskets by reference to the character of the income of the controlled foreign corporation.

In contrast to the definition of control for purposes of defining a related person, the Code treats a foreign corporation as a controlled foreign corporation only if *more* than 50 percent of its stock (by vote or value) is owned (directly, indirectly, or by attribution) by U.S. shareholders. Prior to the Act, the ownership threshold for related party status was, similarly, *more* than 50 percent of the total combined voting power of a corporation's voting stock.

Different thresholds for defining "control" in the definitions of controlled foreign corporation, on the one hand, and related person, on the other, may produce unintended anomalies in the operation of the foreign tax credit limitation baskets, especially where look-through treatment may be involved. For example, assume that a foreign corporation owned 50-50 by two unrelated persons, one foreign and one U.S., derives all of its income from manufacturing, and that it pays royalties to its U.S. shareholder, which derives the royalties in the active conduct of its trade or business. This income of the shareholder is ineligible for the active royalty exception from foreign personal holding company income because the payor is a "related person." However, the foreign corporation is not a controlled foreign corporation, and therefore the royalty income of the shareholder cannot be recharacterized under the look-through to reflect the overall limitation character of the foreign corporation's income. Thus, the royalty is passive basket income of the shareholder, even though it would not have been if the U.S. shareholder owned either more or less than 50 percent of the foreign corporation's stock.

Explanation of Provision

The bill provides that control, for purposes of the related person definition of section 954(d)(3), means direct or indirect ownership of more than 50 percent (by vote or value) of the stock of a corporation or more than 50 percent (by value) of the beneficial interests in a partnership, trust or estate. Therefore, as was true prior to the Act, the definitions of both controlled foreign corporation and related person under subpart F are keyed to the same definition of corporate control.

In the case of royalties derived in the active conduct of a trade or business, for example, the bill prevents treatment of a 50-percent U.S.-owned foreign corporation in a manner which is different than the treatment of both foreign corporations owned more than 50 percent by U.S. persons and foreign corporations owned less than 50 percent by U.S. persons. The bill eliminates, by contrast, the opportunity for a controlled foreign corporation to exclude from foreign personal holding company income, under section 954(c)(3)(A)(i), same-country dividends from a 50-percent owned foreign corporation.

5. Measurement of earnings and profits

Present Law

As noted above, the amount of earnings and profits of a controlled foreign corporation for a taxable year serves as a limitation on the amount of its subpart F income for the year. Except as provided in section 312(k)(4), for purposes of subpart F the earnings and profits (or deficit in earnings and profits) of any foreign corporation for any taxable year generally is determined according to rules substantially similar to those applicable to domestic corporations, subject to regulations.

The Tax Reform Act of 1984 introduced several provisions to make a corporation's earnings and profits more closely conform to its economic income where economic income diverged from taxable income. Under the 1984 Act, for example, a corporation using the LIFO method of accounting for inventory adjusts earnings and profits under rules designed to eliminate the impact of LIFO on earnings and profits (current Code sec. 312(n)(4)). A corporation's earnings and profits for a year in which the corporation sells property on the installment basis generally are to be computed as if the corporation did not use the installment method to account for the installment sale (current Code sec. 312(n)(5)).

A corporation that accounts for income and expenses attributable to a long-term contract on the completed contract method of accounting generally recognizes income and expense in the year in which the contract is completed. Under the 1984 Act, a corporation that accounts for income and expense on this method is required to compute earnings and profits as if it were accounting for income and expense attributable to long-term contracts on a percentage of completion basis (sec. 312(n)(6)).

The effect of these provisions is generally to accelerate the inclusion of amounts in earnings and profits, reducing to some extent amounts of earnings and profits that can be treated as current earnings in future taxable years. In the case of a domestic corporation computing taxable dividends, this reduction in subsequent years' current earnings and profits does not generally reduce the tax on amounts distributed in the subsequent year, because the distribution of accumulated earnings is also taxed.

In the case of computing the subpart F limitation, on the other hand, acceleration of earnings under these provisions generally has the effect of raising the subpart F limitation in an earlier year than the year in which those earnings would be included in taxable income of U.S. shareholders.

The Act put new limits on the amounts by which prior year deficits in earnings and profits, or deficits in non-subpart F income, can be used to reduce subpart F inclusions (sec. 952(c)). Those provisions generally do not, however, provide for increasing the earnings and profits limitation by a prior year excess of earnings and profits over subpart F income, even if those earnings and profits relate to subpart F income categories.

Explanation of Provision

Under the bill, the earnings and profits limitation on subpart F income is to be determined without regard to the rules that accelerate the recognition of earnings and profits from inventory assets accounted for under the LIFO method, from installment sales, and from contracts the income from which is accounted for under the completed contract method. By conforming the computation of earnings and profits for this purpose to the computation of taxable income, the bill ensures that subpart F income inclusions more closely match the controlled foreign corporation's taxable subpart F income. The bill thus reduces the possibility that tax haven income will go untaxed.

The modification also provides, however, that under regulations, if the earnings and profits arising from the inventory assets, installment sale, or completed contract are distributed prior to the year that they would otherwise be included in income (e.g., the year in which the installment receivable is collected or the contract is completed), those earnings are not to be included in income in the later year. This treatment may be necessary to eliminate the potential for those earnings to be taxed twice.

6. Effective date of accumulated earnings tax amendments

Present Law

The Act amended sections 535 and 545 to provide that the accumulated earnings tax and personal holding company tax applicable to a foreign corporation will be calculated by taking net capital gains into account when computing the net capital gain deduction only if they are effectively connected with the conduct of a U.S. trade or business, and only if they are not exempt by treaty from U.S. tax. Congress intended that the amendments apply to gains and losses realized on or after January 1, 1986, rather than only those gains and losses realized after March 1, 1986 as stated in the Act.[1]

Explanation of Provision

The bill amends the effective date of the Act's amendments to section 535 and 545. Under the bill the Act's amendments apply to gains and losses realized on or after January 1, 1986.

7. Dividends received deduction

Present Law

The Act rewrote section 245(a), which governs the deduction for dividends received from foreign corporations, modifying it in several important respects. Under the Act, dividends eligible for the deduction are based on the ratio of (a) the foreign corporation's post-1986 earnings and profits that have been subject to net-basis U.S. corporate income tax and that have not been distributed to (b) the corporation's total accumulated earnings and profits.

Under Code section 1248, where a U.S. person sells or exchanges stock in a foreign corporation (or receives a distribution which is treated as an exchange of stock in a foreign corporation) which was, during the previous 5 years, a controlled foreign corporation in which the U.S. person was a U.S. shareholder, the gain recognized on the sale or exchange is treated as dividend income of the U.S. person to the extent of the earnings and profits of the foreign corporation attributable to such stock and accumulated since 1962 during periods in which the corporation was a controlled foreign corporation and in which the U.S. person held the stock sold or exchanged. For these purposes, certain income items, including generally amounts effectively connected with a U.S. trade or business of the controlled foreign corporation and not exempt from tax (or subject to a reduced tax rate) by treaty, are excluded from earnings and profits. Thus, amounts treated as dividends under section 1248 are generally derived from earnings not subject to U.S. corporate income tax, and therefore generally are not eligible for the dividends received deduction under the Act.

---

[1] *See* H. Rep. 99-841, Vol. II (September 18, 1986), p. 628 (Conference Report).

Explanation of Provision

The bill provides that for purposes of section 245(a), the term dividend does not include any amount treated as a dividend under section 1248. Thus, the bill clarifies that a taxpayer which is treated as having received dividend income due to the sale or exchange of stock in a controlled foreign corporation will not be eligible for a deduction of any portion of the amount treated as a dividend.

D. Special Tax Provisions for U.S. Persons

1. Effective date of provision governing transfers of intangibles to related parties (sec. 112(m) of the bill, sec. 1231 of the Reform Act, and sec. 482 of the Code)

Present Law

The Act requires that payments with respect to intangibles that a U.S. person transfers to a related foreign corporation or possessions corporation be commensurate with the income attributable to the intangible. The new provisions carrying out this rule apply to taxable years beginning after December 31, 1986, but only with respect to transfers after November 16, 1985, or licenses granted after that date (or before that date with respect to property not in existence or owned by the taxpayer on that date). For purposes of section 936, the new provisions apply to taxable years beginning after December 31, 1986, without regard to when any transfer (or license) was made.

In view of the fact that the objective of these provisions—that the division of income between related parties reasonably reflect the relative economic activity undertaken by each—applies equally to inbound transfers, Congress concluded that it would be appropriate for these principles to apply to transfers between related parties generally (via Code sec. 482) if income must otherwise be taken into account. However, in the case of a transfer of the type that is covered by the Act but that would not have been affected by the House version of H.R. 3838, Congress intended to apply the above effective date provision substituting "August 16, 1986" for "November 16, 1985."

Explanation of Provision

In the case of transfers and licenses of intangibles which are not to foreign persons (and not to possessions corporations), and therefore not of the type affected by the House version of H.R. 3838, the bill modifies the relevant effective date provision of the Act. In the case of a transfer or license which is not to a foreign person or a possessions corporation, the bill provides that the Act applies to taxable years beginning after December 31, 1986, but only with respect to transfers after August 16, 1986, or licenses granted after that date (or before that date with respect to property not in existence or owned by the taxpayer on that date). The bill clarifies that for purposes of section 936, which governs income from certain intangibles whether or not the intangibles are actually transferred, the Act's provisions apply to taxable years beginning after December 31, 1986, regardless of whether a transfer (or license) was made.

2. Treatment of certain passive foreign investment companies (sec. 112(n) of the bill, sec. 1235 of the Reform Act, and secs. 904, 1246, 1248, 1291, 1293, 1294, 1296, and 1297 of the Code)

Present Law

Overview

The Act established rules for passive foreign investment companies (PFICs) and established separate rules for each of two types of PFICs. One set of rules applies to PFICs that are "qualified electing funds," where each U.S. shareholder includes currently in gross income his or her share of a PFIC's total earnings, with an election to defer payment of tax, subject to an interest charge, on income not currently received. The second set of rules applies to PFICs that are not qualified electing funds ("nonqualified funds"), whose U.S. shareholders pay tax on income realized from a PFIC and an interest charge which is attributable to the value of deferral.

Definition of passive foreign investment company

General definition

A passive foreign investment company (PFIC) is any foreign corporation if 75 percent or more of its gross income for the taxable year consists of passive income, or any foreign corporation if 50 percent or more of the average value of its assets consists of assets that produce, or are held for the production of, passive income. Passive income for these purposes means generally income that is includible in the passive income separate foreign tax credit limitation (Code sec. 904(d)(2)(A)), without regard to the exceptions contained therein (i.e., without regard to the exceptions to passive income for income included in other separate foreign tax credit limitations, export financing interest, high-taxed income, and foreign oil and gas extraction income). Thus, for example, passive income does not include any dividend received by a corporation from a related corporation organized in the same foreign country as the shareholder if the dividend is excluded from passive income for foreign tax credit purposes. By incorporating the definition of passive income that is applied for foreign tax credit limitation purposes, the look-through rules contained therein (*i.e.*, secs. 904(d)(3) and (d)(5)), are, to the extent applicable, applied in determining whether income is passive for PFIC purposes as well.

Exceptions to PFIC classification

Except as provided in regulations, passive income does not include income derived by bona fide insurance companies that would be subject to taxation under subchapter L if the company were a U.S. corporation. It was intended that regulations provide that entities engaged in the business of providing insurance derive passive income and, thus, may be PFICs in certain cases where the entities maintain financial reserves in excess of the reasonable needs of their insurance business.

In determining whether foreign corporations that own subsidiaries that are primarily engaged in active business operations are PFICs, look-through treatment is provided in certain cases. Under this look-through rule, a foreign corporation that owns at least 25 percent of the stock of another corporation is treated as owning a proportionate part of the other corporation's assets and income. Thus, amounts such as interest and dividends received from foreign or domestic subsidiaries are eliminated from the shareholder's income in applying the income test and the stock or debt investment is eliminated from the shareholder's assets in applying the asset test. It is unclear under the Act whether the look-through rule applies when the 25 percent ownership is indirectly held.

General rule—nonqualified funds

General rule

United States shareholders in PFICs that are not "qualified electing funds" pay U.S. tax and an interest charge based on the value of tax deferral at the time the shareholder disposes of stock in the PFIC or on receipt of an "excess" distribution (Code sec. 1291). Under this rule, gain recognized on disposition of stock in a PFIC or on receipt of an "excess" distribution from a PFIC is treated as ordinary income and is considered as earned pro rata over the shareholder's holding period of his or her investment. Distributions from nonqualified funds are not eligible for a deemed paid foreign tax credit under section 902.

Definition of excess distribution

An "excess" distribution is any current year distribution in respect of a share of stock that exceeds 125 percent of the average amount of distributions in respect of the share of stock received during the 3 preceding years (or, if shorter, the total number of years of the taxpayer's holding period prior to the current taxable year). It is unclear whether excess distributions are included in determining any 3-year average distribution amount in respect of a share of stock.

Although the Act provided for certain adjustments in determining the amount of an excess distribution, the Act did not provide any adjustment for amounts that may be currently included in income under other current inclusion rules.

Anti-avoidance rules

The Act, in addition to incorporating certain anti-avoidance rules in present law section 1246 (relating to foreign investment companies), provided the Secretary the authority to disregard any nonrecognition provision of present law on dispositions of PFIC stock. For example, it is contemplated that regulations may treat a gift of stock in a nonqualified fund to a non-taxpaying entity, such as a charity or a foreign person, as a disposition for purposes of those rules in order that the deferred tax and interest charge attributable to that stock not be eliminated.

Qualified electing funds

General rule

United States persons who own stock in a "qualified electing fund" must include currently in gross income their pro rata share of the PFIC's total earnings and profits. This inclusion rule requires current payment of tax, absent a shareholder-level election to defer tax. A qualified electing fund is any PFIC that properly elects with the Secretary and complies with the requirements the Secretary prescribes to determine the income of the PFIC, to ascertain its stock ownership, and to ascertain any other information necessary to carry out the purposes of those rules.

The amount currently included in income is divided between a shareholder's pro rata share of the ordinary income of a PFIC and net capital gain income of a PFIC. The characterization of income, and the determination of earnings and profits, is made pursuant to general Code rules. Pro rata share of income is determined by aggregating a PFIC's income for the taxable year and attributing that income ratably over every day in the PFIC's year. United States persons then include in income for the period in which they hold stock in the PFIC their daily ownership interest in the PFIC multiplied by the amount of income attributed to each day.

Election to defer current payment of tax

United States investors in qualified electing funds may generally, subject to the payment of interest, elect to defer payment of U.S. tax on amounts currently included in income but for which no current distribution has been received. An election to defer tax is treated as an extension of time to pay tax for which a U.S. shareholder is liable for interest.

Certain events cause an extension of time to pay tax on undistributed earnings to terminate. One of those events is the disposition of stock in a PFIC, which terminates all previous extensions of time to pay tax with respect to the earnings attributable to that stock. It is intended that disposition for this purpose mean any transfer of ownership, regardless of whether the transfer constitutes a realization or recognition event under general Code rules. For example, a transfer at death or by gift of stock of a qualified electing fund is to be treated as a disposition for these purposes.

Special rules applicable to both types of funds

Coordination of section 1291 with taxation of shareholders in qualified electing funds

Gain recognized on disposition of stock in a PFIC by a U.S. investor is not taxed under section 1291 if the PFIC is a qualified electing fund for each of the fund's taxable years which begin after December 31, 1986 and which include any portion of the investor's holding period.

Distributions received from a PFIC in a year the PFIC is a qualified electing fund are also intended not to be taxed under section 1291 if the PFIC is a qualified electing fund for each of the fund's taxable years which begin after December 31, 1986, and which include any portion of an investor's holding period. This provision prevents a fund from retaining its annual income, electing to be a qualified electing fund in a subsequent year, and then distributing the accumulated income without the imposition of an interest charge.

Attribution of ownership

In determining stock ownership, a U.S. person is considered to own his proportionate share of the stock of a PFIC owned by any partnership, trust, or estate of which the person is a partner or beneficiary (or in certain cases, a grantor), or owned by any foreign corporation if the U.S. person owns 50 percent or more of the value of the corporation's stock. However, if a U.S. person owns any stock of a PFIC, the person is considered to own his proportionate share of any PFIC stock owned by the upper-tier PFIC, regardless of the percentage of his ownership in the upper-tier PFIC. In attributing stock ownership, holders of options for stock of a corporation are not treated as owning the stock in the corporation.

Anti-avoidance rules

The Act provided authority to the Secretary to prescribe regulations that are necessary to carry out the purposes of the Act's provisions and to prevent circumvention of the interest charge.

One example where regulations may be necessary to carry out the purposes of the Act's provisions is where the ownership attribution rules attribute stock ownership in a PFIC to a U.S. person through an intervening entity and the U.S. person disposes of his interests in the intervening entity. In these cases, the intervening entity may not be a PFIC, so that the U.S. person could technically avoid the imposition of any interest charge. In this instance, regulations are intended to treat the disposition of interests in the intervening entity as a disposition of the PFIC stock. Similarly, if necessary to avoid circumvention of the Act's interest charge, it may be necessary under regulations to treat distributions received by an intervening entity as being received by the U.S. person.

Coordination with other current inclusion and disposition rules

The Act adopted rules to coordinate the PFIC provisions with the subpart F and FPHC current inclusion rules in the case of qualified electing funds. Under these coordination rules, amounts required to be included in income currently under either section 951 or 551 shall be included first under those rules and then any additional amounts shall be included currently under section 1293. The Act did not provide coordination of the PFIC provisions and the subpart F and FPHC provisions for nonqualified funds.

Explanation of Provision

Definition of passive foreign investment company

The bill makes it explicit that dividends received from certain related corporations organized in the same country as the shareholder (namely, dividends described in sec. 954(c)(3)) are subject to look-through treatment in determining whether a corporation receives passive income. This conforms the treatment of these same country dividends to dividends received from other 25-percent (or more) owned corporations.

The bill clarifies the exception from passive income for income received by bona fide insurance companies. This exception from passive income extends only to income derived by insurance companies that are predominantly engaged in the active conduct of an insurance business and that would be taxed under the special rules applicable to domestic insurance companies if they were domestic corporations. Thus, income derived by entities engaged in the business of providing insurance will be passive income to the extent the entities maintain financial reserves in excess of the reasonable needs of their insurance business.

The bill clarifies that the look-through rule for 25-percent-owned corporations applies to direct or indirect 25-percent ownership that is held by an upper-tier foreign corporation.

The bill treats stock of certain U.S. corporations owned by another U.S. corporation which is at least 25-percent owned by a foreign corporation as active assets. Under this rule, in determining whether a foreign corporation is a PFIC, stock of a regular domestic C corporation owned by a 25-percent owned domestic corporation is treated as an asset which does not produce passive income (and is not held for the production of passive income), and income derived from that stock is treated as income which is not passive income. Thus, a foreign corporation, in applying the look-through rule available to 25-percent owned corporations, will be treated as owning non-passive assets in these cases. This rule does not apply, however, if, under a treaty obligation of the United States, the foreign corporation is not subject to the accumulated earnings tax, unless the corporation agrees to waive any such benefit. This rule is designed to mitigate the potential disparate tax treatment between U.S. individual shareholders who hold U.S. stock investments through a U.S. holding company and those who hold those investments through a foreign holding company. If a foreign mutual fund attempts to use this rule to avoid the PFIC provisions, it will be subject to the accumulated earnings tax and, thus, will lose any potential U.S. tax benefits.

Nonqualified funds

The bill makes several modifications and clarifications to the rules applicable to PFICs that are not qualified electing funds.

The bill eliminates the potential for double taxation by coordinating the nonqualified fund rules with the rules applicable to the Code's other current inclusion rules, the subpart F and the foreign personal holding company rules. Thus, for example, excess distributions will not include any amounts that are treated as previously taxed income under section 959(a) distributed by a controlled foreign corporation that is also a PFIC that is not a qualified electing fund. (Because items of previously taxed income increase a U.S. shareholder's stock basis to the extent those items are not distributed (sec. 961), the deferred tax and interest charge rules of section 1291 that apply to dispositions of stock in a PFIC that is not a qualified electing fund but that is a controlled foreign corporation are not affected by the above-described modifications.)

The bill modifies the determination of an excess distribution to exclude from the 3-year average distribution amount that part of an excess distribution that is considered attributable to deferred earnings (*i.e.*, that part of the excess distribution that is not allocable to pre-PFIC years and to the current year). This modification is necessary to prevent the avoidance of the interest charge that would otherwise be due on accumulated earnings. For example, a PFIC could accumulate earnings for a period of years, and then distribute those earnings ratably over a period greater than three years. If the excess distributions received in the first three years were to be included in the 3-year average distribution amount, distributions received after three years would not be excess distributions, and hence no interest would be imposed on the deferred earnings inherent in those later distributions.

The bill clarifies the determination of a taxpayer's holding period as it relates to receipt of an excess distribution. This clarification provides that a taxpayer's holding period is considered to end on the date of receipt of an excess distribution but only with respect to that distribution. Thus, the taxpayer's holding period in its stock to which the excess distribution is attributable does not end on the date of receipt of the excess distribution.

The bill repeals the Act's provision which denies U.S. corporate shareholders in PFICs that are not qualified electing funds benefits of the indirect foreign tax credit under section 902. Thus, if a U.S. corporation owns at least 10 percent of the stock in a PFIC, the corporation is treated as paying its share of the PFIC's foreign income taxes imposed on the earnings the PFIC distributes to the U.S. corporation.

The bill also makes other clarifications to the Act's provisions applicable to PFICs that are not qualified electing funds. First, the bill clarifies that the deferred tax and interest charge rules of section 1291 do not apply to any distribution received by a taxpayer from a PFIC if the PFIC is a qualified electing fund for all of its years beginning after 1986 for which it is a PFIC and which include any part of the taxpayer's holding period. This treatment parallels the rule for dispositions provided under the Act. Further, the bill clarifies that the regulatory authority provided under the Act to deny the benefits of any nonrecognition treatment extends to any transfers of PFIC stock, including transfers at death or by gift.

Qualified electing funds

The bill also modifies and clarifies the rules applicable to PFICs that are qualified electing funds.

The bill provides that, to the extent provided in regulations, if a qualified electing fund establishes to the Secretary's satisfaction that it maintains records that determine investors' pro rata shares of income more accurately than allocating a taxable year's income ratably over a daily basis (for example, by allocating a month's income ratably over a daily basis), the fund can determine the investors' pro rata shares of income on that basis. This provision is designed to allow those funds that maintain appropriate records to more accurately determine U.S. investors' pro rata shares of income in cases where the investors own their stock for only parts of a year. For example, if a PFIC maintains records on a monthly basis and allows redemptions and acquisitions of its stock only at a month's end, this provision would allow U.S. investors to include in income income actually earned by the PFIC for each month rather than including in income under the general rule their pro rata share of a year's total income.

The bill modifies the determination of a PFIC's earnings and profits. This modification provides that earnings and profits are computed using the installment method of accounting (and the completed contract method of accounting and the LIFO inventory method, if applicable) if a PFIC uses the method to compute its income. For example, if a PFIC uses the installment method of accounting in computing its income, U.S. investors' pro rata shares of income will take into account that method. This modification only affects earnings and profits for income inclusion purposes. Thus, it does not change earnings and profits for purposes of determining, for example, if a distribution is a dividend. The modification also provides, however, that, under regulations, if the earnings and profits arising from the installment method and considered deferred for income inclusion purposes are distributed prior to the year that they would otherwise be included in income (*e.g.*, the year in which the installment receivable is collected), those earnings are not to be included in income in the later year. This latter rule is necessary to eliminate the potential for double taxation of those earnings.

The bill clarifies that disposition, for purposes of determining whether an extension of time to pay tax on undistributed PFIC earnings terminates, means any transfer of stock, regardless of whether it would give rise to a realization or recognition event under general Code rules. For example, a transfer of stock by gift causes a termination of all prior extensions of time to pay tax for the earnings attributable to that stock.

The bill provides modifications to the rules applicable to PFICs that are qualified electing funds that are also controlled foreign corporations. First, the amount of income treated as ordinary income on a sale or exchange of stock in a controlled foreign corporation (under sec. 1248) does not include any amount of income previously included under the qualified electing fund rules to the extent that that amount of income has not been distributed from the PFIC prior to the sale or exchange of stock. Further, look-through treatment is provided in determining the foreign tax credit limitation treatment of income inclusions under the qualified electing fund rules when (1) the PFIC is also a controlled foreign corporation, and (2) the U.S. person with the income inclusion is a U.S. shareholder in the controlled foreign corporation.

Special rules applicable to both types of funds

Attribution of ownership

The bill provides that under regulations any person who has an option to acquire stock shall be treated as owning the stock. It is anticipated that regulations will provide this treatment where necessary to prevent avoidance of the imposition of interest.

Anti-avoidance rules

The bill also provides that under regulations if a U.S. person is treated as owning stock in a PFIC by virtue of the attribution rules, any distribution to the actual holder of the stock is treated as a distribution to the U.S. person. It is anticipated that regulations will provide this treatment where necessary to prevent avoidance of the imposition of interest. In these cases, the bill also provides that the amounts deemed distributed to the U.S. person are not to be included in gross income of the holder actually receiving those amounts for purposes of causing the U.S. person to include those amounts in income again.

E. Treatment of Foreign Taxpayers

1. Branch profits tax (sec. 112(o) of the bill, sec. 1241 of the Reform Act, and secs. 26, 861, 884, 906, and 2104 of the Code)

Present Law

Overview

The Act imposed branch-level taxes on profits of foreign corporations operating businesses in the United States and on interest paid or deducted by U.S. businesses operated by foreign corporations. The Act also reduced the U.S. business threshold that triggers the withholding tax on dividends paid by foreign corporations (applicable where the branch profits tax cannot be applied).

Branch profits tax

A tax of 30 percent is imposed on a foreign corporation's "dividend equivalent amount." The "dividend equivalent amount" is the earnings and profits of a U.S. branch of a foreign corporation attributable to its income effectively connected (or treated as effectively connected) with a U.S. trade or business, subject to two adjustments (detailed below). The determination of effectively connected earnings and profits is made without reduction for dividend distributions made by a foreign corporation during a year, so that tax is imposed on a foreign corporation that has current earnings (which are not reinvested in a branch's trade or business, as detailed below).

In arriving at the dividend equivalent amount, a branch's effectively connected earnings and profits are adjusted in two circumstances. These adjustments identify changes in a branch's U.S. net equity (the difference between a branch's assets that are treated as connected with its U.S. trade or business and its liabilities that are so treated) that reflect profit remittances during a taxable year. The first adjustment to the dividend equivalent amount reduces the tax base to the extent the branch's earnings are reinvested in trade or business assets in the United States (or reduce trade or business liabilities). This reduction is measured by the increase in the U.S. net equity of the branch: the difference between (1) the excess of the money and adjusted basis of the branch's assets over its liabilities at the end of the year and (2) the excess of the money and adjusted basis of its assets over its liabilities at the end of the preceding year. The second adjustment increases the tax base to the extent prior reinvested earnings are considered remitted to the home office of the foreign corporation. This adjustment is measured by the reduction in the U.S. net equity of the branch: the difference between (1) the excess of the money and adjusted basis of the branch's assets over its liabilities at the end of the preceding year and (2) the excess of the money and adjusted basis of the branch's assets over its liabilities at the end of the year. The increase in the tax base on account of a decrease in U.S. net equity is intended to be limited to the amount of prior earnings that have not been remitted to the home office, unless a branch has current earnings.

Branch-level interest tax

Interest paid by a U.S. trade or business of a foreign corporation is treated as if paid by a U.S. corporation and, hence, is U.S. source and subject to U.S. withholding tax of 30 percent, unless the tax is reduced or eliminated by a specific Code or treaty provision. It is intended that where this interest is paid to a U.S. person or a U.S. trade or business of a foreign person, the interest is also to be treated as U.S. source but not subject to withholding since it is subject to tax on a net income basis in the hands of the recipient. To the extent a U.S. branch of a foreign corporation has allocated to it under Treasury Regulation section 1.882-5 an interest deduction in excess of the interest actually paid by the branch (this generally occurs where the indebtedness of the U.S. branch is disproportionately small compared to the total indebtedness of the foreign corporation), the excess is treated as if it were interest paid on a notional loan to a U.S. subsidiary (the U.S. branch, in actuality) from its foreign corporate parent (the home office). This excess is also subject to the 30-percent tax, absent a specific Code exemption or treaty reduction.

For purposes of determining whether the tax on the excess interest is to be reduced or eliminated by treaty, the applicable income tax treaty is the one between the United States and the country of the corporation's home office, subject, however, to the prohibition against treaty shopping. In the case of U.S. withholding tax on interest actually paid by a branch to a foreign recipient, the appropriate treaty will be that between the United States and the country of the recipient, subject again to the prohibition against treaty shopping.

Relationship with tax treaties

The Act provided that the branch profits tax is to yield to treaties only in two cases. The first case is where a foreign corporation with a U.S. branch is a "qualified resident" of a country in which the corporation is a resident (i.e., the corporation is not treaty-shopping) and the treaty prohibits the branch profits tax. The second case is where a foreign corporation resides in a country whose treaty permits the United States to impose its withholding tax on dividends paid by the corporation but otherwise prohibits the branch profits tax, whether or not the foreign corporation is treaty shopping. In this second case, however, the foreign corporation paying the dividends cannot claim any treaty benefits (i.e., reduced rates) with respect to the dividends it pays if it is treaty shopping. The Act also prohibited any foreign corporation that receives a dividend from another foreign corporation from claiming any treaty benefits with respect to the dividends received if it is treaty shopping.

A foreign corporation generally is treaty shopping in two cases: First, treaty shopping occurs if more than 50 percent (by value) of the stock of the foreign corporation is owned (determined by looking through corporations, partnerships, estates, and trusts to ultimate individual ownership) by individuals who are not residents of the treaty country. U.S. citizens and resident aliens are treated as residents of the treaty country for this purpose.

Second, where 50 percent or more of a foreign corporation's income is used to meet liabilities to persons who are not residents of the country in which the corporation is a resident or of the United States, then the corporation is treaty shopping (a "base erosion" rule).

If a foreign corporation's stock is primarily and regularly traded on an established securities market in the country under whose treaty it claims benefits as a resident, then the corporation is considered a qualified resident of that country. Similarly, if a foreign corporation's parent is organized in the same country as its subsidiary corporation, and the parent corporation's shares are primarily and regularly traded on an established securities market in that country, then the subsidiary corporation is considered a qualified resident of the country for purposes of the country's treaty with the United States. Under the Act, the publicly-traded exception does not automatically treat a foreign corporation that is wholly owned by a U.S. corporation whose stock is primarily and regularly traded on an established securities market in the United States as a qualified resident of the country in which it is a resident. A domestic corporation in this instance has to determine (in addition to meeting the base erosion rule) if it is more than 50-percent owned by either U.S. residents or residents of the country of the domestic corporation's subsidiary in order to be treated as a qualified resident.

Other rules

The Act reduced to 25 percent prior law's business income threshold for imposition of the withholding tax on dividends. The Act also provided that the withholding tax on dividends is not applicable where the branch profits tax generally may be imposed, even though no branch tax may be due in a particular taxable year.

For U.S. branches of foreign corporations that have undistributed accumulated earnings and profits as of their first taxable year beginning on or after January 1, 1987, the branch profits tax provisions are intended to apply only to earnings and profits generated in taxable years beginning after December 31, 1986, that are considered distributed from the branch to the home office (limited by post-effective date earnings and profits). Prior law's withholding tax on dividends is intended to apply to the pre-effective date accumulated earnings and profits that are distributed after the effective date. Thus, if a branch's income did not constitute at least 50 percent of the corporation's income for the base period prescribed under prior law, there is no withholding tax imposed on dividends paid after 1986 that represent pre-effective date earnings. Similarly, pre-effective date deficits in earnings and profits are not intended to be eligible to reduce post-effective date earnings in applying the branch profits tax. Post-effective date deficits in earnings and profits do not reduce pre-effective date earnings in applying prior law's withholding tax to distributions after 1986 where the distributions are attributable to pre-effective date earnings.

Explanation of Provision

Branch profits tax

The bill clarifies that the dividend equivalent amount is limited to the post-1986 accumulated effectively connected earnings and profits of the U.S. branch that have not previously been remitted to the branch's home office.

Branch-level interest tax

The bill clarifies that interest paid or deducted by a U.S. trade or business of a foreign corporation is U.S. source, regardless of the recipient. Thus, if the recipient is a foreign person not engaged in a U.S. trade or business the interest will be subject to U.S. withholding tax; if the recipient is a U.S. person or a foreign person engaged in a U.S. trade or business and the interest is effectively connected therewith, the interest will not be subject to withholding but will be subject to U.S. tax in the hands of the recipient on a net income basis.

The bill also modifies the taxation of interest paid by a U.S. trade or business. First, the bill excludes interest paid by international organizations (as defined in sec. 7701(a)(18)) from the scope of the provision. Second, to the extent provided in regulations, the bill will limit U.S. withholding to the amount of interest reasonably expected to be deducted in arriving at the branch's effectively connected taxable income.

Relationship with tax treaties

The bill modifies the applicability of the branch profits tax in cases of treaty shopping. This modification provides that if a foreign corporation is treaty shopping, the branch profits tax will be imposed, regardless of whether the treaty with the United States and the country in which the corporation is a resident allows the United States to impose its withholding tax on dividends. One of the reasons Congress enacted the branch profits tax was the difficulty of administering prior law's withholding tax. The Act's rule—prohibiting the imposition of the branch profits tax in cases where a treaty permits the U.S. withholding tax on dividends paid by a foreign corporation whether or not the corporation is treaty shopping—would not in some cases remedy that concern. For example, assume a treaty with the United States prohibits the branch profits tax but it permits the withholding tax on dividends if the corporation derives 50 percent or more of its income from the United States. Assume further that the foreign corporation organized in this treaty country is treaty shopping. The result of the Act would be to impose the withholding tax on dividends in the years in which the corporation derives 50 percent or more of its income from the United States and to impose the branch profits tax in years in which the corporation's U.S. income is below that level. This result would be difficult to administer and would lead to tax avoidance techniques.

More importantly, however, Congress was concerned that foreign persons resident in one country would attempt to use another country's tax treaty with the United States to avoid the branch profits tax. The bill addresses this concern by not allowing treaties to prevail in treaty shopping cases.

The bill clarifies that the prohibition against treaty shopping of recipients of interest paid or deducted by a U.S. trade or business of a foreign corporation applies to any person attempting to claim benefits under the interest articles of the treaty of the country in which the foreign corporation is a resident. The bill continues to allow, however, the recipient to claim benefits under the treaty in the country in which the recipient is a resident, unless the recipient is treaty shopping as well.

The bill modifies the definition of treaty shopping in two respects. First, the bill provides that if nonresidents of a treaty country own *50 percent or more* of the value of stock of a corporation the corporation is considered treaty shopping. This modification generally accords with the ownership limitation in recent U.S. income tax treaties. Second, the bill modifies the publicly traded exception to treaty shopping to provide that a foreign corporation that is wholly owned by a domestic corporation whose stock is primarily and regularly traded on an established securities market in the United States is to be treated as a qualified resident of its country of residence. This modification accords with the Act's presumption that corporations whose stock is primarily and regularly traded on a local securities market is more than 50 percent owned by local residents and with the Act's treatment of U.S. persons as treaty-country residents.

Other rules

The bill clarifies that the withholding tax on dividends is not imposed for any taxable year with respect to dividends paid out of earnings and profits of the corporation for that year if the branch profits tax may be imposed for that year (even if no branch profits tax may be due in that year). Thus, the withholding tax on dividends may be imposed in two cases. First, the withholding tax may be imposed on dividends that are attributable to pre-1987 earnings and profits. Second, the withholding tax may be imposed on dividends that are attributable to any earnings and profits when the branch profits tax is prohibited by a treaty with the United States, regardless of when the dividends are distributed. Thus, in this latter case, the withholding tax on dividends may be imposed in a year a foreign corporation is subject to the branch profits tax if the dividends are attributable to years in which the branch tax is prohibited, for example, by a treaty.

2. Treatment of deferred payments and appreciation arising out of business conducted within the United States (sec. 112(p) of the bill, sec. 1242 of the Reform Act, and sec. 864(c) of the Code)

Present Law

The Act provides that any income or gain of a nonresident alien individual or foreign corporation for any taxable year which is attributable to a sale or exchange of property, the performance of services, or any other transaction, in any other taxable year shall be treated as effectively connected with the conduct of a trade or business within the United States if it would have been so treated if such income or gain were taken into account in such other taxable year (new Code sec. 864(c)(6)). Similarly, the Act provides that if any property ceases to be used or held for use in connection with the conduct of a trade or business within the United States, the determination of whether any income or gain attributable to a sale or exchange of such property occurring within 10 years after such cessation is effectively connected with the conduct of a trade or business within the United States shall be made as if such sale or exchange occurred immediately before such cessation (new Code sec. 864(c)(7)). Under the Act, the amount of income or gain taken into account under the latter provision is not limited to the appreciation of the property while the property was used in the United States, but rather is based on the amount of income or gain recognized at the time of the sale or exchange.

A foreign corporation engaged in a trade or business during the taxable year is taxable on a net basis on its income which is effectively connected with the conduct of a trade or business within the United States (Code sec. 882(a)). The same treatment applies to nonresident alien individuals (Code sec. 871(b)).

Explanation of Provision

In the case of payments for sales or exchanges of property, the performance of services, or any other transaction, that are deferred from one taxable year to a later taxable year, the determination whether such income or gain is taxable on a net basis (under sec. 871(b) or 882(a)) is to be made as if the income were taken into account in the earlier year and without regard to the requirement (of sec. 871(b) or 882(a)) that the taxpayer be engaged in a trade or business within the United States during the later taxable year. The bill makes a similar amendment to the Act's provision taxing dispositions of property formerly used or held for use in connection with the conduct of a trade or business within the United States and disposed of within 10 years after that cessation of use. For this purpose, the property is treated as being sold or exchanged immediately before it ceased to be used or held for use in connection with the conduct of a trade or business in the United States, and the requirement (of sec. 871(b) or 882(a)) that the taxpayer be engaged in a trade or business within the United States during the taxable year for which such income or gain is taken into account is disregarded.

3. Withholding tax on amounts paid by partnerships to foreign partners (sec. 112(q) of the bill, sec. 1246 of the Reform Act, and secs. 872, 882, and 1446 of the Code)

Present Law

Partnership withholding

Prior to the Act, partnerships that conducted a trade or business in the United States generally were not required to withhold U.S.

tax on distributions to foreign persons that were attributable to the U.S. business income of the partnership. Under the Act, however, partnerships must withhold in these circumstances. This withholding requirement supplements other withholding requirements applicable to certain generally passive U.S. source income derived by partnerships that have foreign partners.

Under the Act, the following withholding rules apply to distributions to foreign partners in U.S. or foreign partnerships that have any income effectively connected with the conduct of a U.S. trade or business. First, withholding at 30 percent (sometimes reduced or eliminated under treaties) is required with respect to distributions attributable to certain U.S. source fixed or determinable annual or periodic income not effectively connected with the conduct of a U.S. trade or business. It is intended that any distribution by the partnership be considered to come first out of these types of income received by the partnership.

Second, any partnership distribution in excess of the amounts described immediately above is subject to withholding at a 20-percent rate. The amount withheld is creditable against the U.S. income tax liability of the foreign partner. Amounts withheld in excess of a foreign person's tax liability are treated as an overpayment of tax.

Third, if a partnership's gross income effectively connected with a U.S. trade or business over a three-year period (or shorter period if the partnership is not in existence for three years) is less than 80 percent of the total gross income of the partnership over that period, then withholding is required only on the proportion of current distributions that the partnership's gross income effectively connected with its U.S. trade or business bears to the partnership's total gross income over its previous three taxable years (or shorter period if the partnership is not in existence for three years).

Fourth, the Act provides that, unless otherwise provided in regulations, withholding is not required if substantially all of the U.S. source income and substantially all of the income effectively connected with a partnership's U.S. trade or business is allocable to U.S. partners pursuant to a valid special allocation under section 704(b) and the regulations thereunder. This provision exempting amounts from withholding is not intended to apply to a partnership which has only U.S. source income and in which foreign persons hold only a minority interest such that, on a straight allocation, "substantially all" of the partnership's income could be considered to be allocated to U.S. persons. Instead, it is intended to apply only to a partnership which specially allocates its U.S. source income to U.S. persons and its foreign source income to foreign persons.

Taxation of foreign persons

Nonresident alien individuals and foreign corporations generally are subject to U.S. tax only on their gross income which is derived from U.S. sources and which is not effectively connected with the conduct of a trade or business in the United States and on their gross income which is effectively connected with the conduct of a trade or business in the United States (secs. 872(a) and 882(b)). United States tax on the former type of gross income generally is collected by withholding whereas U.S. tax on the latter type of gross income generally is collected by the filing of a U.S. tax return and payment of estimated taxes.

Explanation of Provision

Partnership withholding

The bill modifies the rule that requires withholding only on a proportion of current distributions by a partnership if the partnership's gross income effectively connected with its U.S. trade or business is less than 80 percent of the partnership's total gross income. For this purpose, gross income, the denominator of the fraction, does not include any U.S. source fixed or determinable annual or periodical income (i.e., income that is described in sec. 1441(b)) which is not effectively connected with the conduct of the partnership's U.S. trade or business.

The bill modifies the exception to 20-percent withholding for amounts already subject to U.S. withholding tax on a gross basis (except where eliminated by treaty). This exception is extended to certain types of U.S. source income that are exempt from U.S. tax under the Code, that is, to portfolio interest and bank deposit interest. Thus, amounts that are subject to U.S. withholding tax at a 30-percent rate (or a lower treaty rate) or that would be subject to withholding but for a Code or treaty exemption are not subject to the 20-percent withholding rule. Distributions by a partnership would be considered to come first out of these types of income received by the the partnership.

The bill clarifies the exception to 20-percent withholding for partnerships with certain special allocations of partnerships' distributive shares. This clarification provides that the exception applies only to a partnership which specially allocates its U.S. income to U.S. persons and its foreign income to foreign persons.

Taxation of foreign persons

The bill clarifies the meaning of gross income for nonresident alien individuals and foreign corporations. Under the bill, sections 872(a) and 882(b) are modified so that, for those persons, unless the context clearly indicates otherwise, gross income includes only gross income which is derived from sources within the United States and which is not effectively connected with the conduct of a trade or business within the United States, and gross income which is effectively connected with the conduct of a trade or business within the United States. For example, when the taxpayer at issue is a nonresident alien individual or a foreign corporation, gross income subject to direct U.S. income tax includes only that gross income which is derived from U.S. sources and which is not effectively connected with the conduct of a U.S. trade or business and that gross income which is effectively connected with the conduct of a U.S. trade or business. By contrast, a partnership's gross income, for purposes of determining the proportion of distributions by a partnership that is subject to 20 percent withholding, is all income from whatever source derived (as determined under sec. 61), except as specifically modified by the change described above. Thus, a partnership's gross income will include its gross income derived from foreign operations in addition to that gross income derived from its U.S. operations.

4. Income of foreign governments (sec. 112(r) of the bill, sec. 1247 of the Reform Act, and sec. 892 and 893 of the Code)

Present Law

The Act provides that the income of foreign governments received from investments in the United States in stocks, bonds, or other domestic securities owned by such foreign governments is not included in gross income and is exempt from income taxation (Code sec. 892). In addition, the Act provides that the exemption does not apply to any income received from or by a controlled commercial entity. The Act's legislative history indicates that, for treaty purposes, a foreign government is to be treated as a resident of its country, unless it denies similar treaty benefits to the United States.

In certain cases, wages, fees, or salary of an employee of a foreign government received as compensation for official services to such government is excluded from gross income and is exempt from income taxation (Code sec. 893).

Explanation of Provision

The bill makes it clear that the Code provision benefiting certain income of foreign governments (sec. 892) neither excludes from gross income nor exempts from tax income derived from the disposition of any interest in a controlled commercial entity. Thus, this Code provision does not benefit such income, whether or not such income is received from investments in the United States in stocks, bonds, or other domestic securities owned by a foreign government. Such income may not be taxable for independent reasons: for example, a sale of stock of a U.S. corporation that is not a U.S. real property interest by a foreign person may not be subject to tax under general Code rules. For this purpose, however, a commercial entity is to include any U.S. real property holding corporation (Code sec. 897(c)(2)).

In addition, the Code's exclusion from gross income and exemption from taxation do not apply to income received indirectly from a controlled commercial entity (as well as to income received directly from such an entity). For example, assume that a foreign government owns all the shares of a U.S. holding company that owns all the shares of a U.S. operating company. The U.S. holding company deducts all the dividends it receives from the operating company by virtue of the 100-percent dividends received deduction. Under the bill, dividends from the holding company to the foreign government are not exempt, because they are received indirectly from a controlled commercial entity.

The bill codifies the rule that a foreign government, for income tax treaty purposes, is treated as a corporate resident of its country if it grants equivalent treatment to the U.S. government. In addition, for purposes of the Internal Revenue Code, a foreign government is treated as a corporate resident of its country (whether or not it treats the U.S. government as a U.S. resident).

The bill conforms the gross income exclusion and tax exemption for wages, fees, or salary of an employee of a foreign government to the exclusion and exemption for governments themselves. Under the bill, the exclusion and exemption are not available to an employee of a foreign government whose services are primarily in connection with a commercial activity (whether within or outside the United States) of the foreign government, or to any employee of a controlled commercial entity of a foreign government.

5. Dual residence companies (sec. 112(s) of the bill, sec. 1249 of the Reform Act, and sec. 1503 of the Code)

Present Law

The Act provides that if a U.S. corporation is subject to a foreign country's tax on worldwide income, or on a residence basis as opposed to a source basis, any net operating loss it incurs cannot reduce the taxable income of any other member of a U.S. affiliated group for that or any other taxable year. A net operating loss of such a company is referred to as a "dual consolidated loss." Regulatory authority is provided to exclude a loss from the ambit of this rule to the extent that that loss does not offset the income of foreign corporations for foreign tax purposes.

Explanation of Provision

The bill provides that, to the extent provided in regulations, any loss of any separate and clearly identifiable unit of a trade or business of the taxpayer is to be treated as a dual consolidated loss as if that unit were a wholly owned subsidiary of that corporation. For example, assume that a U.S. corporation maintains a branch in a foreign country. That foreign country allows the loss of that branch to offset the taxable income of a locally incorporated corporation that is wholly owned by the U.S. corporation (or an affiliate of the U.S. corporation). The branch incurs, for both U.S. and foreign tax purposes, a net operating loss of $100. The foreign corporation earns income of $100. The U.S. corporation, viewed as a whole, has neither gain nor loss for the year: the $100 loss of the branch offsets $100 of income generated by the rest of the U.S. corporation. Under the bill, regulations may provide that the branch's $100 loss is treated as a dual consolidated loss. It is anticipated that regulations will so provide to the extent that the branch's loss offsets the income of a foreign corporation for foreign purposes. In that case, that loss may not be used to offset the income that the U.S. corporation earns other than from the branch operation. Thus, the taxable income of the U.S. corporation is $100. The branch's $100 loss is available for carryforward against future income of the branch.

F. Foreign Currency Exchange Rate Gains and Losses (sec. 112(t) of the bill, sec. 1261 of the Reform Act, and secs. 986-989 of the Code)

1. Foreign currency translation

Present Law

Translation of foreign income taxes

Generally for purposes of computing either the direct or indirect foreign tax credit, the amount of foreign income taxes paid to a foreign government or U.S. possession is translated, under subpart J of the Code as added by the Act, using the exchange rate in effect as of the time of payment; any refund or credit of a foreign income tax is translated using the exchange rate in effect as of the time of the original payment; and any increase in the amount of a foreign income tax is intended to be translated using the exchange rate in effect when the increase is paid. (Congress did not intend the payment date rule to prevent the allowance of a credit based on accrued foreign taxes where those taxes are unpaid when the credit must be computed.)

Translation of section 956 income inclusions

On the actual distribution of earnings and profits from a foreign corporation to a U.S. taxpayer, the latter is required to translate such amounts (if necessary) at the current exchange rate on the date the distribution is included in income. In the case of deemed distributions under section 951(a) of subpart F, the required income inclusion is first calculated in the functional currency and then translated at the weighted average exchange rate for the foreign corporation's taxable year. The Secretary may adjust these translation rates by regulation.

Where earnings of a controlled foreign corporation are repatriated, the Code generally aims at achieving similar tax results whether the repatriation is in the form of a dividend or of an increase in investment in U.S. property (*see* secs. 951(a)(1)(B) and 956). However, the translation rules described above provide for computing translation rates differently depending on the form of repatriation. Congress did not intend to provide taxpayers their choice of tax results based on translation method where a similar economic result is achieved in either case.

Explanation of Provisions

Translation of foreign income taxes

The bill clarifies that the exchange rate to be used for determining the dollar cost of any payment of foreign income tax (including a payment constituting an adjustment to a payment of foreign tax) is the exchange rate as of the time the taxes are paid to the foreign country or U.S. possession. The bill applies this rule whether the entity paying the tax to the foreign government or U.S. possession is the taxpayer or (as in the case where the taxpayer claims an indirect foreign tax credit) a corporation of which the taxpayer is a shareholder, and whether or not the tax is paid by a qualified business unit.

Translation of section 956 income inclusions

The bill provides that subpart F inclusions under section 951(a)(1)(B), relating to increases in investments in U.S. property, are to be translated at the same rates as actual distributions made on the last day of the taxable year, i.e., using the spot rate on that day. This reduces the opportunity for taxpayers to manipulate tax liability based on the foreseeable difference between the weighted average annual rate and the spot rate as of the date when earnings repatriation is to occur. The Secretary retains authority to further adjust translation rates, under regulations, where regulatory adjustments can usefully promote the aim of reducing similar opportunities for manipulation.

2. Foreign currency transactions

Present Law

Section 988(c) defines the term "section 988 transaction" to include (1) the acquisition of (or becoming the obligor under) a debt instrument, (2) the disposition of nonfunctional currency, and (3) entering into or acquiring any forward contract, option, or similar financial instrument (such as a currency swap), if such instrument is not marked to market at the close of the taxable year under section 1256. Congress did not intend to change generally the treatment of bank forward contracts, regulated futures contracts, or other contracts subject to the mark-to-market rule under section 1256. Therefore, Congress intended to exclude such instruments from the definition of a section 988 transaction.

Section 988(b) defines foreign currency gain or loss as gain or loss on a section 988 transaction, but only to the extent the gain or loss is realized by reason of a change in exchange rates between the booking date with respect to that transaction and the payment date of the transaction. In the case of any disposition of nonfunctional currency, the relevant period for measuring rate changes is the time between acquisition and disposition of the currency.

For transactions involving forward contracts or similar positions, the booking date is the date on which the position is entered into or acquired; the payment date includes the date on which a taxpayer's rights are terminated with respect to the position (e.g., by entering into an offsetting position). The definition of foreign currency gain or loss is intended to apply to gain or loss attributable to exchange rate movements between those dates affecting the value of forward contracts or similar instruments, regardless of the particular transaction in which the gain or loss is realized.

The Secretary has general authority to provide the regulations necessary or appropriate to carry out the purposes of new subpart J. For example, where a debt instrument, the acquisition of which is a section 988 transaction, is converted to stock, the sale of which is not a section 988 transaction, the Act gives the Secretary the authority to prevent any foreign currency gain inherent in the debt instrument from escaping subpart J treatment.

The Act authorizes the issuance of regulations that address the treatment of transactions that are part of a section 988 hedging transaction. To the extent provided in regulations, in the case of any transaction giving rise to foreign currency gain or loss that is part of a section 988 hedging transaction (determined without regard to whether any position in the hedge would be marked to market under section 1256), all positions in the hedging transaction are integrated and treated as a single transaction, or otherwise treated consistently (e.g., for purposes of characterizing the nature of income or the sourcing rules). In the case of a foreign currency borrowing fully hedged with a series of forward purchase contracts, for example, Congress intended that regulations treat the entire package as a dollar borrowing with dollar interest payments subject to the rules of section 1271 et seq. and 163(e) for determining the appropriate interest deduction.

Explanation of Provisions

Exclusion from section 988 treatment for 1256 contracts

The bill provides that if a forward contract, futures contract, option, or similar financial instrument would have been marked to market under section 1256 were it held on the last day of the taxable year, then the instrument is not a "section 988 transaction" even if it is not actually marked to market under section 1256 *at the close of the taxable year*. This amendment clarifies that taxpayers who acquire 1256 contracts cannot elect 988 rules for characterizing, timing, and sourcing or allocating the income or loss on such contracts simply by disposing of the contracts prior to the last day of the taxable year.

Measurement of foreign currency gain or loss

The bill provides that any gain or loss from a section 988 transaction is a foreign currency gain or loss if the transaction is a disposition of nonfunctional currency or a forward contract, futures contract, option, or similar financial instrument with respect to a nonfunctional currency. This makes it clear that any gain or loss on such an instrument due to forward premium or forward discount is subject to the Act's rules for foreign currency gains and losses, regardless of movements in the spot rates of exchange between the booking and payment dates. Further, any gain or loss on a nonfunctional currency disposition is foreign currency gain or loss regardless of whether the difference between acquisition and disposition prices is due to spot rate movements between acquisition and disposition dates, forward discount or premium, bid-asked spreads, or other factors.

Recognition of gain or loss on delivery under a futures contract, etc.

The bill provides that making or taking delivery under a section 988 transaction that is a forward contract, futures contract, option or similar financial instrument is a gain or loss recognition event (*cf.* sec. 1256(c)), and the payment date in such a case is the date of making or taking delivery. This rule prevents taxpayers from opting for alternate treatment on such a transaction by selling or otherwise closing out the position, on the one hand, or taking or making delivery, on the other. Under a transitional provision, this rule will not change the treatment of deliveries taken by a taxpayer on or before the date of the bill's introduction.

Section 988 hedging transactions

The bill provides that where all transactions that are part of a section 988 hedging transaction are integrated and treated as a single transaction or otherwise treated consistently under regulations, such treatment applies for purposes of all provisions in subtitle A of the Code. Thus the bill makes clear Congress's intent that Code provisions other than section 988 are to be applied to the components of a section 988 hedging transaction in their integrated or otherwise combined state (where regulations provide for such integration or combination).

G. Tax Treatment of Possessions (sec. 112(u)-(x) of the bill, secs. 1274-1277 of the Reform Act, and sec. 932 of the Code)

Present Law

Mirroring of Virgin Islands coordination rule

The Act contains a new provision coordinating U.S. and Virgin Islands income taxes (Code sec. 932). That Code section does not apply for purposes of determining income tax liability incurred to the Virgin Islands. The intent of Congress in not having that provision apply for V.I. tax purposes was to prevent any argument that 48 U.S.C. 1397 (the provision of the Naval Appropriations Act of 1922 that holds the U.S. income tax laws, as amended, to be "likewise in force in the Virgin Islands") or the Revised Organic Act of the Virgin Islands could require "mirroring" of the new coordination provision for internal Virgin Islands purposes.

Treatment of Virgin Islands residents

The Act provides that in the case of an individual who is a bona fide resident of the Virgin Islands at the close of the taxable year and who, on his or her return of income tax to the Virgin Islands, reports income from all sources and identifies the source of each item shown on such return, for purposes of calculating income tax liability to the United States, gross income shall not include any amount included in gross income on the V.I. return.

Effective date of prohibition of branch tax

The provisions of the Act applicable to Guam, American Samoa, and the Northern Mariana Islands generally apply only if and so long as an implementing agreement under Act section 1271 is in effect between the United States and such possession. The Act provides that, for branch tax purposes, certain corporations created or organized in Guam, American Samoa, the Northern Mariana Islands, or the Virgin Islands, the branch tax does not apply. This provision is to be mirrored, so that the branch tax does not apply to U.S. corporations with operations in any of those possessions.

Explanation of Provision

Mirroring of Virgin Islands coordination rule

The bill provides that in applying Code section 932 (the provision coordinating U.S. and Virgin Islands income taxes) for purposes of determining income tax liability incurred to the Virgin Islands, the provisions of Code section 932 are not to be affected by any provision of Federal law described in Code section 934(a), i.e., the Naval Appropriations Act or the Revised Organic Act. Thus, while there is not to be "mirroring" of this provision, this provision, insofar as it determines the taxable income of Virgin Islands residents, has effect for V.I. tax purposes.

Treatment of Virgin Islands residents

The bill adds to the bona fide resident requirement and the reporting requirement a third requirement for exclusion of items reported on a V.I. return. That further requirement is that the individual seeking the exclusion fully pay his or her tax liability (referred to in sec. 934(a)) to the Virgin Islands with respect to income from all sources. In addition, the bill provides that in the case of an individual whose gross income excludes amounts included on a V.I. return, allocable deductions and credits are not to be taken into account.

Effective date of prohibition of branch tax

The bill makes it clear that the rule prohibiting the imposition of the branch tax on certain corporations organized in the possessions (and thus the prohibition of imposition of the branch tax by a possession on a U.S. corporation) applies for taxable years beginning after December 31, 1986.

H. Miscellaneous Foreign Provisions

1. Relationship with treaties (sec. 112(y) of the bill, Title VII and Title XII of the Reform Act, and sec. 7852 of the Code)

Present Law

In general, when a statute and a treaty provision conflict, the one adopted later controls. When Congress enacted the Internal Revenue Code of 1954, it included in that Code (sec. 7852(d)) a statement that no provision of the Internal Revenue title, *i.e.*, the Internal Revenue Code, was to apply in any case where its application would be contrary to any treaty obligation of the United States in effect on the date of enactment of the 1954 Code (August 16, 1954). The intent of that provision was to provide a transitional rule to ensure that the substitution of the 1954 Code for the preexisting 1939 Code did not operate to override then-existing treaty provisions. A House bill provision amending Code section 7852(d) to reflect that intent—that post-1954 statutory changes not yield to pre-1954 treaties—was inadvertently dropped in the 1986 Tax Reform Act.

In a number of respects, the interaction between the Act and U.S. treaties is unclear.

Explanation of Provision

The bill modifies the 1954 transition rule (embodied in Code sec. 7852(d)) governing the relationship between treaties and the Code to clarify that it does not prevent application of the general rule providing that the later in time of a statute or a treaty controls (Code sec. 7852(d)). The bill provides that no provision of the Internal Revenue title that was in effect on August 16, 1954, shall apply in any case where its application would be contrary to any treaty obligation of the United States in effect on the date of enactment of the 1954 Code (August 16, 1954). This provision makes it clear that treaty provisions that were in effect in 1954 and that conflict with the 1954 Code as originally enacted are to prevail over then-existing statutes but not over later-enacted statutes.

The bill clarifies the interaction between the 1986 Act and provisions of U.S. treaties. The bill provides that the following provisions of the 1986 Act will not apply to the extent that their application would be contrary to any income tax treaty obligation of the United States in effect on the date of enactment of the 1986 Act (October 22, 1986): subsections (b) and (c) of section 1212 of the Act (imposing a 4-percent gross withholding tax on certain transportation income earned by foreign persons and amending the rules that allow a reciprocal exemption for certain transportation income earned by foreign persons); section 1247 of the Act (relating to the exemption that the United States provides to foreign governments in some cases); and section 1242 of the Act insofar as it relates to new Code section 864(c)(7) (treating gain from sale of assets used in a U.S. trade or business as effectively connected income after cessation of the trade or business in certain cases). In addition, in the event of conflict with an income tax treaty, the source rules of section 1212(a) of the Act (governing the source of certain transportation income), of section 1214 of the Act (governing the source of payments from 80/20 companies) will not apply except for purposes of the foreign tax credit limitation. Further, the provisions of section 1241 of the Act that relate to new Code section 884(f)(1)(A) (to the extent that that provision treats interest paid in excess of interest deducted as U.S. source) and to Code section 861(a)(2)(B) (reducing the fraction of U.S. income that exposes a foreign corporation to U.S. withholding tax on dividend payments it makes) will not apply in the event of a treaty conflict. In addition, in the event of conflict with an income tax treaty, the source rules of section 1211 of the Act (determining the source of income from certain sales of personal property) will not apply to individuals treated as residents of a treaty country under a U.S treaty.

The bill's amendments to Act section 1211, described above, provide a coordination rule for cases where sales of stock yield foreign source income under an income tax treaty and U.S. source income under new Code section 865.

The bill provides that the following provisions of the 1986 Act will apply notwithstanding any treaty provision in effect on the date of enactment of the 1986 Act (October 22, 1986): section 1201 of the Act, amending the foreign tax credit limitation, and section 701 of the Act (as it relates to the limitation on the use of foreign tax credits against minimum tax liability).

Except for cases that have been identified in the bill or in the Act, no cases are known where a harmonious reading of the Act and U.S. treaties is not possible. It is understood that Congress intended harmonious construction of the Act and U.S. income tax treaties to the extent possible. Thus, in some cases, despite the existence of technical arguments alleging the existence of a conflict, it is understood that no conflict exists. For example, it is understood that no nondiscrimination provision of any U.S. treaty bars the application of reasonable collection mechanisms designed to ensure the collection of a tax, the imposition of which is permitted by the treaty. Thus, it is understood that the Act's partnership withholding provision (new Code sec. 1446), which is refundable in appropriate cases, constitutes such a reasonable collection mechanism, and, thus, is fully consistent with existing U.S. treaty obligations.

Similarly, it is understood that the Act's imposition of tax on installment gains received after a foreign person ceases a U.S. trade or business (Act section 1242) is fully consistent with existing U.S. treaty obligations. Some treaties prevent imposition of U.S. tax on business profits of a foreign person unless those profits are attributable to a permanent establishment through which the foreign person carries on business in the United States. It is understood that these treaties do not prevent imposition of U.S. tax on income that was, when realized, attributable to a permanent establishment, even though that income is recognized after the permanent establishment no longer exists. Under a similar analysis, it is understood that the Act creates no conflict with treaties in taxing amounts earned for personal services in the United States which are paid after the person earning the income no longer maintains a U.S. presence.

Other Act provisions that are understood to be fully consistent with U.S. treaty obligations include the Act's dual residence company provisions (Act sec. 1249) and the Act's branch level interest tax provisions (Act sec. 1241). In the latter case, the obligation for U.S. tax on a foreign corporation's "excess interest" arises from the foreign corporation's deduction of interest on amounts payable to third-party lenders. The mere collection of this tax at one time (i.e., the end of the corporation's taxable year) from the foreign corporate payor of interest, rather than requiring the payor to withhold U.S. tax on interest payments made throughout its taxable year, does not make the tax discriminatory.

Similarly, requiring recognition of gain by a domestic corporation that is liquidating into a foreign parent corporation or engaging in a tax-free reorganization where the domestic corporation's assets are being removed from U.S. taxing jurisdiction does not violate any nondiscrimination clause. In some cases, provisions based on capital ownership prohibit imposition of more burdensome taxes on foreign-owned U.S. enterprises than on similar U.S.-owned U.S. enterprises. For this purpose, however, a U.S. enterprise transferring assets to a shareholder who will bear U.S. corporate level tax on the income generated by those assets is not similar to a U.S. enterprise transferring assets to a shareholder who will not bear U.S. corporate level tax on the income generated by those assets. Thus, the Act's provision recognizing gain in these cases (sec. 631(d)) (and the bill's provision making modifications thereto) is fully consistent with U.S. treaty obligations.

If, in any of the cases described above where conflicts are understood not to exist, any treaty is somehow read to bar operation of the Act, the Act is to be effective notwithstanding the treaty.

Notwithstanding Congress' intent that the Act and income tax treaties be construed harmoniously to the extent possible, conflicts other than those addressed in this bill or in the Act ultimately may be found to exist. Therefore, the bill provides that except as otherwise provided by the bill or the Act, the provisions of the 1986 Act will apply notwithstanding any treaty provision in effect on the date of enactment of the 1986 Act (October 22, 1986). If any such now-unknown conflict is ultimately found, it is expected that full legislative consideration of that conflict will take place to determine whether application of the general later-in-time rule is appropriate.

In addition, this technical corrections bill is understood not to conflict with any treaty. Again, should a conflict ultimately appear, the bill's provisions are to take effect.

2. Foreign personal holding companies (sec. 112(z)(1) of the bill, sec. 1810(h) of the Reform Act, and secs. 551 and 552 of the Code)

Present Law

Estates and trusts owning shares of foreign personal holding companies

United States shareholders in a foreign personal holding company (FPHC) are subject to current U.S. tax on their pro rata share of the company's undistributed FPHC income. The FPHC rules were enacted in 1937 to prevent U.S. taxpayers from accumulating income tax-free in foreign "incorporated pocketbooks."

In 1937 there was no statutory definition distinguishing estates and trusts that were U.S. taxpayers (for revenue act purposes in general) from those that were not. For purposes of the FPHC rules, an estate or trust was considered a "U.S. shareholder" in an FPHC unless gross income of the estate or trust for federal income tax purposes included only income from U.S. sources. Subsequently the Code was amended to include generally applicable definitions of the terms "foreign estate" and "foreign trust." (Under current law, these terms mean an estate or trust, as the case may be, the income of which, from sources outside the United States which is not effectively connected with a U.S. trade or business, is not includible in gross income under the Code's income tax provisions (sec. 7701(a)(31)).)

The foreign personal holding company rules contain a tracing rule, added by the Tax Reform Act of 1984, to make it clear that U.S. taxpayers cannot avoid the FPHC rules by interposing foreign entities between themselves and a FPHC. The 1984 Act grants regulatory authority to the Secretary of the Treasury to provide for such adjustments in the FPHC rules as may be necessary to carry out the purposes of this tracing rule. The 1986 Act included a technical amendment to the tracing rule to clarify that the tracing rule applies to all foreign trusts and estates (as defined for Code purposes generally) interposed between U.S. taxpayers and FPHCs.

Same country dividend and interest exception

The 1984 Act provided that dividends and interest received by a foreign corporation from a person (1) related to the recipient, (2) organized in the same country as the recipient corporation, and (3) having a substantial part of its assets used in its trade or business located in that same country, generally do not count in either the numerator or the denominator of the fraction that is used in determining whether the foreign corporation is an FPHC. The 1986 Act provided a definition of related person for this purpose.

Explanation of Provisions

Estates and trusts owning shares of foreign personal holding companies

Under the bill, estates and trusts that are shareholders in an FPHC are U.S. shareholders for purposes of the FPHC rules unless they are foreign estates or trusts under the general Code definitions of those terms. The bill clarifies that the 1986 Act's amendment to the FPHC tracing rules treats estates and trusts as intervening foreign entities if and only if they are foreign estates and foreign trusts under the general Code definitions.

The bill provides that in making adjustments to the tracing rules by regulation, the Secretary may impose rules similar to the rules of Code section 1297(b)(5) (as amended by the bill) applicable to passive foreign investment companies (PFICs). These rules would provide for similar treatment, under regulations, of distributions from FPHCs, on the one hand, and entities through which FPHC ownership is attributed, on the other. For example, where stock ownership in a FPHC is attributed to a U.S. person through an intervening entity, it is anticipated that regulations would treat distributions received by the intervening entity as being received by the U.S. person. (As discussed above, the bill makes a technical change to section 1297(b)(5) to clarify that under regulations if a U.S. person is treated as owning stock in a PFIC by virtue of the attribution rules, any distribution to the actual holder of the stock is treated as a distribution to the U.S. person.) These regulations will prevent reduction of FPHC income by virtue of distributions that result in no U.S. tax.

Same country dividend and interest exception

The bill makes amendments to the 1984 and 1986 Act provisions relating to the same country dividend and interest exception to FPHC income treatment. One such amendment defines a new term, "related person dividend or interest," as a same country dividend or same country interest of the type excluded from FPHC income under the 1984 Act. The bill restores related person dividend and related person interest to the denominator of the fraction used in determining whether a foreign corporation is an FPHC. The bill also restores FPHC income treatment of a related person dividend or interest to the extent the dividend or interest is attributable to income of the related person which would be FPHC income.

Thus, for example, where the entire amount of a foreign corporation's income is related person dividends and related person interest, and in any taxable year some of that income, but less than 50 percent, is attributable to income of the related person which would be FPHC income, the bill prevents the foreign corporation from being treated as an FPHC.

Attribution of dividends and interest to income of the related person is to be determined under rules similar to the foreign tax credit look-through provisions for dividends and interest paid to a U.S. shareholder by a controlled foreign corporation. Under such rules a dividend paid out of the earnings and profits of a corporation is to be treated by the recipient as FPHC income in proportion to the FPHC earnings and profits out of which the dividend was paid, divided by the total earnings and profits out of which the dividend was paid (*cf.* sec. 904(d)(3)(D)). Similarly, interest received or accrued from a corporation is to be treated as FPHC income to the extent properly allocable (under regulations prescribed by the Secretary) to FPHC income of the corporation (*cf.* sec. 904(d)(3)(C)).

All of the bill's provisions described above regarding foreign personal holding companies apply to taxable years of foreign corporations beginning after December 31, 1986.

3. Withholding on pensions, annuities and certain other deferred income (sec. 112(z)(2) of the bill, sec. 1234(b) of the Reform Act, and sec. 3405 of the Code)

Present Law

The Act provides that pension benefits (and similar payments) are subject to withholding under section 3405 if delivered outside the United States. The election generally available to U.S. persons to forego withholding under section 3405 is not available in such cases. Congress enacted this provision with a view to taxing persons who reside abroad yet are likely to owe U.S. income tax on pension benefits (and similar payments) that they receive.

Explanation of Provision

The bill clarifies that the Act's automatic withholding rule does not apply if the recipient certifies to the payor that he or she is not a U.S. citizen or a resident alien of the United States, and not a tax avoidance expatriate. Thus under the bill the automatic withholding rule generally applies to foreign-delivered pension benefits and similar payments to individuals subject to U.S. income taxation on their worldwide income.

In addition, the bill restricts automatic withholding under the Act to those benefits and payments that are delivered outside both the United States and its possessions. Thus, recipients of benefits and payments delivered in any U.S. possession would continue to be eligible to elect to forego withholding on the same terms available to taxpayers whose payments or benefits are delivered in the United States. These amendments would apply to distributions made after the date of the bill's enactment.

4. Information exchange (sec. 112(z)(3) of the bill, sec. 1876(e) of the Reform Act, and sec. 6103 of the Code)

Present Law

Tax returns and return information generally may not be disclosed by government employees except as specifically provided in the Code. Violation of the nondisclosure rules may result in sanctions, including criminal felony conviction in the case of a willful violation. One Code exception to the general nondisclosure rule permits disclosure of a return or return information to a competent authority of a foreign government which has an income tax convention, gift and estate tax convention, or other convention relating to the exchange of tax information with the United States, but only to the extent provided in, and subject to the terms and conditions of, the convention.

In 1983, the Caribbean Basin Economic Recovery Act authorized the Secretary of the Treasury to negotiate and conclude bilateral and multilateral agreements for the exchange of information with designated "beneficiary countries" under the Caribbean Basin Initiative (CBI). Congress expected that these agreements would generally become effective on signature, without need of prior approval by the Senate. These agreements with CBI beneficiary countries are treated as income tax conventions for purposes of the Code provision described above authorizing disclosures of tax returns and return information pursuant to conventions.

The 1986 Act provided that a country may qualify as a host country for foreign sales corporations (FSCs) by entering into an exchange of information agreement of the type provided for in the Caribbean Basin Economic Recovery Act, whether or not that country is eligible to be a CBI beneficiary.

Explanation of Provision

The bill clarifies that tax returns and return information may be disclosed to a competent authority of a foreign government where the disclosure is made pursuant to a bilateral agreement relating to the exchange of tax information with the United States. Thus, where a country other than a CBI "beneficiary country" enters into a bilateral information exchange agreement of the type that qualifies it as a FSC host country under the Act, for example, the bill provides express protection to individuals who make disclosures in accordance with the terms of the agreement from Code sanctions for unauthorized disclosures. By contrast, however, the bill does not contemplate the release of information under multilateral agreements involving non-CBI countries.

5. Maintaining the source of U.S. source income (sec. 112(z)(4) of the bill, sec. 1810(a) of the Reform Act, and sec. 904(g) of the Code)

Present Law

Prior to the 1984 Act, a U.S. taxpayer could convert U.S. source income to foreign source income by routing the income through a foreign corporation: interest and dividend payments from (and income inclusions with respect to) an intermediate foreign corporation generally were foreign source income to the U.S. taxpayer. As foreign source income, the income could be free of U.S. tax under the foreign tax credit.

The 1984 Act added to the foreign tax credit new "resourcing" rules that prevent U.S. taxpayers from converting U.S. source income into foreign source income through the use of an intermediate foreign payee. These rules apply to 50-percent U.S.-owned foreign corporations only. They treat certain payments from, and income inclusions (*e.g.*, under the subpart F anti-tax haven provisions) arising on account of, 50-percent U.S.-owned foreign corporations, as U.S. source.

The 1986 Act made it clear that the source maintenance rules apply notwithstanding any contrary U.S. treaty obligation.

Explanation of Provision

The bill provides new treatment for any amount derived from a 50-percent U.S.-owned foreign corporation that the statute would treat as U.S. source income (because it is attributable to an item of

U.S. source income earned by that foreign corporation) but that the taxpayer, pursuant to any U.S. income tax treaty, treats as foreign source income. To the extent attributable to an item of U.S. source income earned by that foreign corporation, the taxpayer's inclusion is treated as foreign source income that is subject to a separate foreign tax credit limitation. It is anticipated, however, that for administrative convenience the Secretary may allow grouping of similar items that are similarly taxed by a foreign country.

XIII. Tax-Exempt Bond Provisions (Sec. 113 of the bill, secs. 1301, 1302, and 1311-1318 of the Reform Act, and secs. 25, 103, and 141-150 of the Code)

1. Qualified small-issue bonds

Present Law

Allowance of post-sunset date refundings

Qualified small-issue bonds may be issued to finance manufacturing facilities through December 31, 1989. Authority to issue qualified small-issue bonds for nonmanufacturing facilities expired after December 31, 1986.

The Reform Act allows qualified small-issue bonds issued after August 15, 1986, to be refunded after the applicable sunset date of authority to issue the type of bond involved, if—

(a) the refunding bond has a maturity date not later than that of the refunded bond;

(b) the amount of the refunding bond does not exceed the amount of the refunded bond;

(c) the interest rate on the refunding bond is lower than the interest rate on the refunded bond; and

(d) the net proceeds of the refunding bond are used to redeem the refunded bond not later than 90 days after the date of issuance of the refunding bond.

No comparable provision was contained in the 1954 Code which governs such refundings of bonds originally issued before August 16, 1986. (*See*, Reform Act sec. 1313(a).)

$40-million-per-beneficiary limit

Interest on small-issue bonds is not tax-exempt if the aggregate face amount of exempt-facility and qualified small-issue bonds (including equivalent prior-law IDBs) allocated to any beneficiary of the small-issue bonds exceeds $40 million. An exception to this rule is provided for certain current refundings of qualified small-issue bonds, under the same conditions as apply to post-sunset date refundings of such bonds (as described above).[1]

Explanation of Provisions

Allowance of post-sunset date refundings

The bill clarifies that post-sunset date current refundings (including a series of such refundings) of qualified small-issue bonds (including small-issue IDBs), which bonds are originally issued before the applicable sunset date for the type of small-issue bond involved, qualify for tax-exemption, without regard to whether the refunded (original) bonds were issued before August 16, 1986, and without regard to the requirement included in the Reform Act that the interest rate on the refunding bonds be lower than the rate on refunded bonds. Such refundings of bonds originally issued after August 15, 1986, are permitted under sec. 144(a)(12) of the 1986 Code, as modified by the bill. Refundings of bonds originally issued before August 16, 1986, are permitted under a parallel rule which is added by the bill to the 1954 Code. Under this latter rule, bonds may qualify to be refunded if they could have been originally issued on August 15, 1986 (e.g., the "substantially all" (90 percent) requirement of the 1954 Code applies rather than the new 95 percent use requirement).

---

[1] In the case of refundings of bonds originally issued before August 16, 1986, the 90-day limit on completing a refunding is reduced to 30 days. *See*, Title XVIII of the Reform Act.

Post-sunset date refundings of qualified small-issue bonds are permitted under the bill provided that—

(a) the average maturity of the issue of which the refunding bond is a part does not exceed the average maturity of the bonds being refunded by such issue,[2]

(b) the amount of the refunding bond does not exceed the outstanding amount of the refunded bond, and

(c) the net proceeds of the refunding bond are used to redeem the refunded bond not later than 90 days after the date of issuance of the refunding bond.

As indicated above, the bill replaces the limitation on the maturity of each refunding bond, contained in the Reform Act, with a limitation on the average maturity of the refunding issue (as compared to the average maturity of the refunded bonds). However, the bill provides that any refunding bond issued before July 1, 1987, which complied with the requirement as contained in the Reform Act, is treated as satisfying the new requirement.

The bill also extends the 1954 Code sunset date for small-issue IDBs for manufacturing facilities, from December 31, 1988, to December 31, 1989. This change permits bonds for manufacturing facilities which were issued before August 16, 1986 to be refunded through December 31, 1989, without regard to the special limitations (described above) that apply to post-sunset date refundings.

$40-million-per-beneficiary limit

In conjunction with the amendments described above, the bill makes conforming changes to the refunding exception from the $40-million-per-beneficiary limit on qualified small-issue bonds. Thus, for purposes of this exception also, the weighted average maturity of the refunding bonds is compared to that of the refunded bonds, and the requirement that the refunding bonds have a lower interest rate than the rate on the refunded bonds is deleted. The bill further clarifies that a series of refundings may qualify under this exception. As under the rules for post-sunset date refundings, refunding bonds issued before July 1, 1987, which complied with the maturity requirement as contained in the Act, are treated as meeting the new requirement.

---

[2] Average maturities, for this purpose, are determined in the same manner as for purposes of the limitation on private activity bond maturity to 120 percent of the economic life of the property being financed.

2. Student loan bonds

Present Law

Tax-exemption is authorized for interest on qualified student loan bonds, including bonds issued in connection with the Federal GSL and PLUS programs and certain State supplemental student loan programs. Bonds issued in connection with the Federal GSL and PLUS programs must be used to finance loans that are both (1) guaranteed by the Department of Education and (2) eligible for student assistance (SAP) payments (unless such payments are precluded solely by virtue of the tax-exempt status of the bonds). Additionally, the interest charged to student borrowers must be restricted as provided in the Higher Education Act of 1965. Bonds that meet some, but not all, of these requirements (e.g., bonds the proceeds of which are used to make student loans that receive Federal guarantees, but for which SAP payments are not available) may in certain cases not meet the definition of State supplemental student loan bonds and therefore may not qualify for tax exemption.

Explanation of Provisions

The bill clarifies that student loan bonds that fail to satisfy some but not all of the requirements of Title IV of the Higher Education Act of 1985 may be issued under the exception for State supplemental student loan bonds, provided that the bonds otherwise satisfy all requirements applicable to tax-exempt supplemental student loan bonds.

The bill clarifies that an issue may not qualify as an issue of qualified student loan bonds if the issue satisfies the trade or business use and security interest tests contained in the Reform Act (Code secs. 141(b)(1) and (2)). For purposes of this provision, "use" by a section 501(c)(3) educational institution solely by reason of its administration of a student loan program does not affect the tax-exempt status of an issue, provided such use does not constitute an unrelated trade or business of the institution.

3. Qualified 501(c)(3) bonds

Present Law

Present law permits tax-exemption for interest on bonds to benefit section 501(c)(3) organizations (qualified 501(c)(3) bonds). The Reform Act provides that no more than $150 million of such bonds (other than hospital bonds) may be outstanding with respect to any section 501(c)(3) organization at any time. Tax exemption of bonds issued before August 16, 1986, is not affected by the provision; however, such bonds count in applying the provision to bonds issued after August 15, 1986.

In the case of pre-August 16, 1986 bonds, only the nonhospital portion of a mixed-use bond counts toward the $150-million limitation. Whether such allocations are permitted for such mixed-use bonds issued after August 15, 1986, is not specified in the Reform Act.

Explanation of Provisions

The bill clarifies that the proportional allocation rule included in the $150-million-per-beneficiary limit for qualified 501(c)(3) bonds, for mixed hospital/nonhospital use issues, applies to bonds issued after August 15, 1986, as well as to bonds issued before August 16, 1986.

The bill also adds a statutory reference clarifying that related party rules, similar to those applied for purposes of the $40-million-per-beneficiary limitation on qualified small-issue bonds, are to apply under the $150-million limitation.

4. Mortgage revenue bonds and mortgage credit certificates

Present Law

Under present law, authority to issue qualified mortgage bonds (including refundings of such bonds) terminates after December 31, 1988. Before enactment of the Reform Act, this termination date was December 31, 1987. These bonds may not be refunded after expiration of authority to issue them.

Current refundings (including a series of refundings) of qualified mortgage bonds originally issued before August 16, 1986, remain subject to the 1954 Code. (*See*, Reform Act sec. 1313(a).) Thus, bonds originally issued before August 16, 1986, may not be refunded after December 31, 1987.

The Reform Act generally amends the provisions governing issuance of mortgage credit certificates (MCCs) to parallel the qualified mortgage bond provisions. However, the Reform Act incorrectly retained the 1987 termination date for the MCC program, rather than extending it to parallel the 1988 termination of authority to issue qualified mortgage bonds.

Explanation of Provisions

The bill extends the 1954 Code sunset date for qualified mortgage bonds from December 31, 1987, to December 31, 1988, to parallel the 1988 sunset contained in the 1986 Code. This permits qualified mortgage bonds issued before August 16, 1986, to be refunded through December 31, 1988. As was stated in the legislative history accompanying the Act for refundings occurring before January 1, 1988, refundings permitted under this expansion of the transitional exception may not involve an extension of the period for providing financing to homebuyers.

Authority to elect to issue mortgage credit certificates is extended through December 31, 1988, to parallel the qualified mortgage bond expiration date.

5. Private activity bond volume limitation

Present Law

Subject to certain exceptions, State volume limitations are imposed on the issuance of (i) private activity bonds and (ii) the private use portion (in excess of $15 million) of governmental issues. Bond volume authority generally may be allocated only to facilities located within the State making the allocation. Under a limited exception, volume authority may be allocated to private activity bonds for out-of-State water-furnishing, sewage and solid waste disposal, and qualified hazardous waste disposal facilities, if the issuer establishes that the State's share of the use (or output) of the facility will equal or exceed its share of the private activity bonds issued to financed for the facility.

State volume authority may be carried forward for up to three years for certain specified purposes.

Explanation of Provision

The bill expands the circumstances in which State volume authority may be allocated to certain out-of-State facilities to permit such allocations for out-of-State facilities financed with governmental bonds, the private use portion of which exceeds $15 million, if the governmental facilities (a) are equivalent to any of the categories for which out-of-State allocations are permitted in the case of private activity bonds (i.e., water-furnishing facilities, sewage and solid waste facilities, and qualified hazardous waste disposal facilities), or (b) are governmental output facilities financed with tax-exempt bonds. Because of the limitation to $15 million per facility for private use financing for output facilities (other than water-furnishing facilities), this provision will only apply to refundings of such output facility bonds originally issued before September 1, 1986.

Allocations with respect to governmental bonds are permitted only if the State's share of the use (or output) of the private use portion of the bond-financed facility equals or exceeds the State's share of volume authority allocated to the facility.

6. Public approval requirement for private activity bonds

Present Law

In order for interest on a private activity bond to be tax-exempt, a public hearing must be held and issuance of the bonds approved by an elected public official or legislative body. (Alternatively, issuance of the bonds may be approved by a voter referendum.) Subject to certain exceptions, this requirement must be satisfied by the governmental unit issuing the bonds (or on behalf of which the bonds are issued) and all other jurisdictions in which the bond-financed property (or part of it) is located.

Explanation of Provision

The bill clarifies that, in the case of qualified scholarship funding bonds, the public approval requirement for private activity bonds is to be satisfied by a governmental unit which requested organization of the qualified scholarship funding corporation, or requested it to exercise power. (*See*, sec. 150(d)(2)(B).)

7. Limitation on bond-financing of issuance costs

Present Law

At least 95 percent of the proceeds of each issue of private activity bonds must be used to finance the exempt purpose of the issue.

Amounts used to finance any costs of issuance are not treated as spent for the exempt purpose of the borrowing. Thus, these costs may be financed only from the so-called 5-percent "bad money" portion of an issue. Additionally, the amount of private activity bond financing that may be used to finance costs of issuance (other than such costs attributable to financing of credit enhancement fees eligible for special treatment under the arbitrage restrictions) is limited to two percent of the aggregate face amount of the issue. (For mortgage revenue bond issues not exceeding $20 million, this 2-percent limit is increased to 3.5 percent.)

Explanation of Provision

The bill clarifies that the 2-percent (3.5-percent) limitation on bond-financing of certain private activity bond issuance costs is applied to the proceeds, rather than the aggregate face amount, of an issue. Thus, no more than 2 percent of the proceeds of a private activity bond issue (3.5 percent, for mortgage revenue bond issues having proceeds of $20 million or less) may be used to finance most issuance-related costs.

This provision is effective for bonds issued after June 30, 1987.

8. Arbitrage rebate requirement

Present Law

General requirement

Issuers of all tax-exempt bonds are required to rebate certain arbitrage profits earned on nonpurpose investments acquired with gross proceeds of the bonds. The amount required to be rebated is determined, and paid, on an issue-by-issue basis. Ninety percent of the rebate required with respect to any issue must be paid at least once each five years, with the balance being due no later than 60 days after retirement of the issue.

Exception for certain TRAN financings

Arbitrage profits are not required to be rebated with respect to an issue if all gross proceeds are expended for the governmental purpose of the issue within 6 months of the issue date. The Reform Act provides a special "safe harbor" for applying this exception to tax and revenue anticipation notes (TRANs). Under this safe harbor, if during the six-month period after the issue date, the cumulative cash-flow deficit of the governmental unit using the TRAN proceeds exceeds 90 percent of the aggregate face amount of the issue, all net proceeds of the TRAN issue (and any earnings thereon) are deemed to have been spent for the purpose of the issue.

Exception for small governmental units

The Reform Act provides a further exception to the rebate requirement for bonds issued by a governmental unit having general taxing powers, if (a) 95 percent or more of the net proceeds of the issue are to be used for local governmental activities of the issuing governmental unit (or a governmental unit entirely within the jurisdiction of the issuing governmental unit), and (b) the governmental unit reasonably expects to issue no more than $5 million of tax-exempt bonds during the calendar year in which the issuance occurs. In determining whether an issuer reasonably expects to exceed the $5-million limitation, bonds issued by the issuing governmental unit and all entities that are subordinate to it under applicable State or local law are counted. Private activity bonds are not counted toward the limit and do not qualify for this exception.

Bonds to be redeemed (other than in an advance refunding) with the proceeds of a later issue are not taken into account for purposes of the $5-million limit. This has the effect of preventing "double counting" of the refunded and refunding bonds, if the refunded and refunding bonds are issued in the same calendar year.

Exception for certain qualified student loan bonds

The Reform Act provides a limited transitional exception to the rebate requirement for qualified student loan bonds issued before January 1, 1989, in connection with the Federal GSL and PLUS programs. Under this exception, the rebate requirement does not apply to amounts earned from investing bond proceeds during an initial 18-month temporary period if—

(a) the earnings are used to pay costs of issuance financed with the bonds; or

(b) the earnings are used to pay administrative costs of the student loan program attributable to the issue and the costs of carrying the issue, but only to the extent that the proceeds of the issue are used to make or finance qualified student loans before the end of the 18-month temporary period.

This exception applies only to the extent issuers are not otherwise reimbursed for these costs.

Explanation of Provisions

Due date of final rebate payments

The bill provides a special rule for determining the due date of the final installment of rebate payments in the case of certain short-term governmental financings. Under this rule, a series of issues that are redeemed during a 6-month period (or such longer period as the Treasury Department may prescribe) are to be treated, at the election of the issuer, as one issue, provided that no bond which is part of any issue in the series (a) has a maturity of more than 60 days (or such longer period as the Treasury may prescribe) or (b) is a private activity bond.

Exception for certain TRAN financings

The bill clarifies that the expenditure determination for the "safe harbor" exception to the rebate requirement for certain tax or revenue anticipation notes (TRANs), is determined by reference to the proceeds, rather than the aggregate face amount, of an issue. Thus, under the clarification, net proceeds of an issue are treated as expended for the governmental purpose of the issue on the first day (after the date of issuance) on which the cumulative cash flow deficit to be financed by the issue exceeds 90 percent of the issue proceeds.

This provision is effective for bonds issued after June 30, 1987.

Exception for small governmental units

Aggregation of entities

Under the Reform Act, bonds of a governmental unit with general taxing powers may qualify for the special exception from arbitrage rebate only if the governmental unit and all subordinate entities reasonably expect to issue no more than $5 million of tax-exempt bonds (other than private activity bonds) during the calendar year. The bill clarifies the reference to subordinate entities contained in the Reform Act to provide that issuers are to be aggregated, for purposes of applying the $5-million limitation, as follows:

(a) An issuer, and all entities which issue bonds on behalf of that issuer, are to be treated as one issuer.

(b) If one issuer is subordinate to another entity, but does not issue bonds on behalf of the other entity, bonds issued by the subordinate entity are to be taken into account in applying the $5-million limitation to such other entity.

(c) Any entity that is formed or, as provided in Treasury regulations, availed of to avoid the purposes of the $5-million limitation and all other entities purporting to benefit from such a device are treated as one issuer.

Treatment of refundings

The bill clarifies that a current refunding bond is not considered in determining whether an issuer otherwise qualifies for the small-issuer rebate exception provided the amount of the refunding issue does not exceed the outstanding (redeemed) principal amount of the refunded bond. Advance refunding bonds are considered in determining whether an issuer reasonably expects to issue $5 million or more in bonds in the same manner as new money bonds.

Refunding bonds (both current and advance) are themselves eligible for this exception from rebate only if (a) the refunded bond qualified for, and was taken into account under, the $5 million exception when issued,[3] (b) the aggregate face amount of the issue of which the refunding bond is a part does not exceed $5 million, (c) except in the case of refunded issues having a weighted average maturity of 3 years or less, the weighted average maturity of the refunding bonds does not exceed the weighted average maturity of the refunded bonds, and (d) no bond which is part of the refunding issue has a maturity in excess of 30 years (measured from the date of issuance of the refunded bonds).

Effective date

The amendments to the small governmental unit rebate exception apply generally to bonds issued after June 30, 1987. A special rule is provided permitting governmental units qualifying for the exception to elect to treat the amendments as if included in the Tax Reform Act of 1986 (i.e., as applying to bonds issued after August 31, 1986).

---

[3] Bonds issued before September 1, 1986, that would have qualified for the exception when issued had the new arbitrage restrictions applied to the issue of which they were a part are treated as satisfying this requirement.

Exception for certain qualified student loan bonds

The Reform Act provides a transitional exception from the rebate requirement for temporary period earnings of certain qualified student loan bonds, which earnings are used to pay otherwise unreimbursed costs. The bill clarifies that (a) amounts paid by student loan borrowers as interest are not to be taken into account in determining whether an issuer is reimbursed for costs under this provision, and (b) in the case of bonds eligible for this rebate exception, except as provided otherwise in future Treasury regulations, amounts earned under the exception also may be taken into account in determining yield on the student loans (i.e., interest payments by student borrowers at rates generally established by the U.S. Department of Education for GSL and PLUS bonds, will not be treated as reimbursed under present Treasury regulations).

9. Prohibition of Federal guarantees

Present Law

Interest on Federally guaranteed bonds does not qualify for tax-exemption. An exception is provided (*inter alia*) for any guarantee by the Bonneville Power Authority pursuant to the Northwest Power Act (16 U.S.C. sec. 839d), as such provision was in effect on July 18, 1984, if the bonds are issued before July 1, 1989.

The District of Columbia generally is not treated as a U.S. instrumentality for purposes of the Federal guarantee prohibition, and accordingly is permitted to issue tax-exempt obligations. The District is however treated as a U.S. instrumentality in the case of certain private activity bonds. Under the Act, these include exempt-facility, qualified small-issue, student loan, and qualified redevelopment bonds, if such bonds are secured other than as revenue bonds.

Explanation of Provision

The bill clarifies that the exception to the Federal guarantee prohibition for any guarantee by the Bonneville Power Authority pursuant to the Northwest Power Act (16 U.S.C. sec. 839d), as such act was in effect on July 18, 1984 (i.e., the date of enactment of the Tax Reform Act of 1984), is a permanent provision.

The bill further clarifies that issuance of qualified redevelopment bonds, by the District of Columbia is not precluded by the prohibition on Federal guarantee of tax-exempt bonds solely by virtue of a pledge of tax security as required for such bonds under the Code.

10. Change in use rules

Present Law

Under the Reform Act, deductions for interest and certain other charges are denied if property financed with private activity bonds is used in a manner not qualifying for tax-exempt financing with the type of bond involved at any time before the bonds are redeemed.

Explanation of Provision

The bill clarifies that users of qualified small-issue bond proceeds, like users of the proceeds of other private activity bonds, are subject to the new change in use penalties. A change in use of facilities financed with qualified small-issue bonds is deemed to occur if, for example, post-issuance capital expenditures result in the $10-million small-issue size limitation being violated, or if bond-financed facilities are used in a manner specifically prohibited by the Code.

11. Bonds issued by volunteer fire departments

Present Law

Certain volunteer fire departments are qualified to issue tax-exempt bonds for specified purposes, notwithstanding that the fire departments may not be governmental units (or acting on behalf of such units) within the meaning of the Code. The Reform Act does not specify whether these bonds are private activity bonds.

Explanation of Provision

The bill clarifies that bonds issued by certain volunteer fire departments (sec. 150(e)) are treated as private activity bonds only for purposes of the public approval requirement and the prohibition on advance refunding of private activity bonds. (These bonds are treated as governmental bonds for all other Code purposes.)

This extension to these bonds of the public approval requirement and the prohibition on advance refundings is effective for bonds issued after June 30, 1987.

12. Bonds issued under certain State programs

Present Law

The Reform Act authorizes tax-exemption for interest on bonds issued as part of the Texas Veterans' Land Bond Program, the Oregon Small Scale Energy Conservation and Renewable Resource Loan programs, and the Iowa Industrial New Jobs Training Program. The Reform Act permits annual bond volume authority to be carried forward for most purposes for which private activity bonds may be issued. Carryforwards of annual bond volume authority are not addressed for bonds issued pursuant to these four programs.

Explanation of Provision

The bill clarifies that bonds issued under the Texas Veterans' Land Bond Program, the Oregon Small Scale Energy Conservation and Renewable Resource Loan programs, and the Iowa Industrial New Jobs Training Program qualify for carryforward elections under the applicable private activity bond volume limitations, beginning with elections for the calendar year 1987 volume limitations. Further, the bill clarifies that bonds issued under the Iowa program are treated as satisfying the limitation on bond maturity to 120 percent of the economic life of the assets financed, if the weighted average maturity of the issue does not exceed 20 years.

13. Effective dates

Present Law

Mortgage credit certificate (MCC) targeting rules

The amendments to the mortgage credit certificate (MCC) targeting rules made by the Act apply to MCCs issued to qualifying homebuyers after August 15, 1986.

Rebate requirement for qualified veterans' mortgage bonds

Under the Act, the extension of the rebate requirement to all tax-exempt bonds generally applies for bonds issued after August 31, 1986 (in the case of certain bonds that were governmental bonds under prior law) or December 31, 1985 (in the case of most other bonds). A special effective date applies in the case of bonds used to fund certain pools. There is no general transitional exception to this requirement.

Prohibition of advance refunding of pension arbitrage bonds

The Act expands the arbitrage yield restrictions to apply, *inter alia,* to investments in annuity-type contracts (e.g., pension arbitrage bonds) and other investment-type property. The restriction on annuity contract investments applies to bonds (including refunding bonds) issued after September 25, 1985.

Prohibition of abusive devices in connection with advance refundings

The Act prohibits the use of any device intended to produce arbitrage profits in connection with an advance refunding, effective with respect to bonds issued after December 31, 1986. No inference was intended that such devices were permitted before enactment of the Act.

Repeal of qualified mortgage bond policy statement requirement

Under prior law, issuers of qualified mortgage bonds and MCCs were required to submit to the Treasury Department annual statements explaining their policies in distributing bonds and credits. The Act repealed this requirement.

Explanation of Provisions

Mortgage credit certificate (MCC) targeting rules

The bill clarifies that the amendments to the MCC targeting rules are effective with respect to elections to trade-in qualified mortgage bond authority for authority to issue MCCs, which elections are made after August 15, 1986. Thus, credits for which elections to trade-in bond authority had been made before August 16, 1986, but which are actually distributed after that date, continue to be subject to the prior-law targeting rules.

Rebate requirement for qualified veterans' mortgage bonds

The bill clarifies that the arbitrage rebate requirement applies to current refundings of qualified veterans' mortgage bonds issued before January 1, 1986, if such refunding bonds are issued after June 30, 1987.

Prohibition of advance refunding of pension arbitrage bonds

The bill clarifies that the arbitrage restriction on investment in annuity contracts prohibits advance refundings (as well as new issues) of so-called "pension bonds" after September 25, 1985. Advance refunding of such bonds issued under project-specific transitional exceptions also is prohibited.

Prohibition of abusive devices in connection with advance refundings

The bill clarifies that the Reform Act's prohibition on abusive devices in connection with advance refundings applies to bonds issued after August 31, 1986. As provided in the legislative history accompanying the Reform Act, no inference is intended that these devices were permitted under prior law.

Information reporting and public approval requirements

The bill clarifies that the extensions of the information reporting requirement to all bonds and of the public approval requirement to all private activity bonds apply to bonds issued after December 31, 1986. Bonds that were subject to these requirements under prior law continued to be so subject if issued between August 15, 1986, and December 31, 1986.

Repeal of qualified mortgage bond policy statement requirement

The bill clarifies that the repeal of the annual policy statement requirement for qualified mortgage bonds was effective for refunding bonds (as well as new money issues) issued after August 15, 1986.

14. Transitional exceptions

Present Law

Transitional exception for certain advance refundings

A transitional exception to various requirements of the Act is provided for certain advance refunding bonds. Bonds that were IDBs or private loan bonds under prior law may not be advance refunded under this exception.

Refundings of certain bonds issued pursuant to transitional exceptions

Bonds issued pursuant to general transitional exceptions

The Reform Act includes a general transitional exceptions for certain bonds for facilities that were "in progress" on September 25, 1985 (Reform Act sec. 1312), and for certain current refundings of bonds originally issued before August 16, 1986 (Reform Act sec. 1313(a)).

Bonds issued pursuant to certain project-specific exceptions

Under the Reform Act, project-specific transitional exceptions generally are limited to a specified amount of bonds (Reform Act secs. 1316(g) and 1317). The treatment of current refunding issues for purposes of these limitations is not specified.

Treatment for volume limitation purposes

Advance refundings of certain output facility bonds

The State private activity bond volume limitations generally are effective for bonds issued after August 15, 1986. Transitional exceptions are provided under specified circumstances (Reform Act sec. 1315).

A special rule applies to advance refundings of bonds issued before August 16, 1986, if the bonds were governmental bonds when issued. Under this rule, the refunding bonds are subject to the volume limitation, to the extent of the nongovernmental use of issue in excess of $15 million, if 5 percent or more of the proceeds of the issue was used to finance output facilities (other than facilities for furnishing water).

Qualified redevelopment bonds

Under the Reform Act, bonds issued pursuant to project-specific transitional exceptions (Reform Act sec. 1317), and which would not have been subject to volume limitations under prior law, are exempt from the new private activity bond volume limitation.

The Reform Act provides project-specific transitional exceptions for bonds to finance several redevelopment projects (Reform Act sec. 1317(6)). The Reform Act specifies that bonds issued pursuant to these exceptions are to be treated as bonds which would not have been subject to volume limitations under prior law. (*See*, Reform Act sec. 1315(e).)

Treatment under alternative minimum tax of bonds issued pursuant to transitional exceptions

Interest on private activity bonds (other than qualified 501(c)(3) bonds) issued after August 7, 1986,[4] is treated as a preference item for purposes of the alternative minimum tax. This treatment does not apply to refundings (including a series of refundings) of bonds originally issued before August 8, 1986.

Under a special provision, interest on bonds issued pursuant to certain project-specific transitional exceptions (Reform Act sec. 1317) is not treated as a preference item, if the bonds would not have been IDBs or private loan bonds under prior law. Bonds issued pursuant to the general transitional exceptions for certain "in progress" facilities and for certain refunding bonds, as well as exceptions for bonds transitioned under prior tax Acts which exceptions are reenacted (Reform Act sec. 1316(g)), are not eligible for this exception. Interest on these bonds is therefore a preference item under the alternative minimum tax if the bonds are private activity bonds, as defined under present law.

---

[4] This date is extended to August 31, 1986, in the case of certain bonds that were governmental bonds under prior law.

Carryforwards for certain bonds issued pursuant to transitional exceptions

The Reform Act contains no general rule allowing volume cap carryforwards for bonds issued pursuant to transitional exceptions. Certain transitioned bonds (e.g., bonds which are specifically described as belonging to a category for which carryforward elections are permitted under present law) may qualify for carryforward elections under the substantive volume limitation rules.

Project-specific transitional exceptions

The Reform Act provides transitional exceptions to indicated provisions for various specifically described projects.

Explanation of Provisions

Transitional exception for certain advance refundings

Under the Reform Act, bonds that were IDBs or private loan bonds under prior law do not qualify under the transitional exception for certain advance refunding bonds (Reform Act sec. 1313(b)). The bill clarifies that the determination of whether a bond was a private loan bond is to be made without regard to any exception to the private loan bond definition, except the exception for so-called "excluded loans" (former sec. 103(o)(2)(C)). Thus (e.g.), IDBs, mortgage revenue bonds and student loan bonds are treated as private loan bonds for purposes of this provision, and may not be advance refunded under the transitional rule; however, bonds used to make loans that enable the borrower to finance a governmental tax or assessment of general application for an essential governmental function may qualify under the transitional exception provided the tax-assessment bonds would not have been IDBs under the prior-law definition.

Refundings of certain bonds issued pursuant to transitional exceptions

Bonds issued pursuant to general transitional exceptions

The bill clarifies the conditions under which bonds issued pursuant to the general transitional exception for certain "in-progress" projects (Reform Act sec. 1312) may be currently refunded, while continuing to qualify for transitional relief. Such bonds are required to meet satisfy both (a) the provisions of the Reform Act that apply to bonds issued under the transitional exception for in-progress projects (Reform Act sec. 1312(b)(1)), and (b) the provisions that apply under the general transitional exception for current refunding bonds (Reform Act sec. 1313(b)(3)).

Bonds issued pursuant to certain project-specific exceptions

Where a transitional exception is limited to a specified amount of bonds (Reform Act secs. 1316(g) and 1317), the bill clarifies that bonds issued pursuant to the exception may be currently refunded, under specified circumstances, without the refunding counting against this dollar limit. This allowance applies to a refunding (including a series of refundings) of a transitioned bond, provided that—

(a) the weighted average maturity of the refunding issue does not exceed the weighted average maturity of the refunded bonds;

(b) the amount of the refunding bond does not exceed the outstanding principal amount of the refunded bond; and

(c) the refunded bond is redeemed within 90 days of the issuance of the refunding bond.

Treatment for volume limitation purposes

Advance refundings of certain output facility bonds

The bill clarifies that the rule subjecting the private use portion of advance refundings of pre-August 16, 1986, bonds to the State private activity bond volume limitations, if 5 percent or more of the net proceeds were used for output facilities, applies notwithstanding the general transitional exception contained in Reform Act section 1315 for certain bonds that were governmental bonds under prior law.

Qualified redevelopment bonds

Qualified redevelopment bonds that are the subject of project-specific transitional exceptions (Reform Act sec. 1317(6)) generally are exempt from the new State volume limitations. The bill clarifies that this treatment does not apply to any bonds issued pursuant to these exceptions which would have been tax-exempt IDBs (as defined under the 1954 Code) if the bonds had been issued before August 16, 1986. (Bonds for a purpose that would not have qualified for tax-exemption under prior law may not be issued under these transitional exceptions.)

This provision is effective for bonds issued after June 10, 1987.

Treatment under alternative minimum tax of bonds issued pursuant to transitional exceptions

The bill clarifies the treatment under the individual and corporate alternative minimum taxes of interest on bonds issued pursuant to various transitional exceptions. Under this clarification, interest on bonds issued pursuant to transitional exceptions generally is not treated as a preference item for purposes of the individual or corporate alternative minimum taxes, unless the bonds would have been IDBs or private loan bonds if issued on August 7, 1986. This clarification applies to bonds issued pursuant to the general transitional exceptions for certain bonds (Act secs. 1312 and 1313), the continuing exceptions for certain bonds that received transitional relief under prior tax acts (Act sec. 1316(g)), and project-specific transitional exceptions (Reform Act sec. 1317).

Carryforwards for certain bonds issued pursuant to transitional exceptions

The bill clarifies that carryforward elections under the new State volume limitations are permitted for bonds (except qualified small-issue bonds) issued pursuant to transitional exceptions (e.g., bonds authorized under Reform Act secs. 1312 and 1317).

Amendments to project-specific transitional exceptions

The bill clarifies that the new limitations on bond-financing of costs of issuance (sec. 147(g)) apply to bonds issued pursuant to project-specific transitional exceptions (Reform Act sec. 1317), unless otherwise expressly provided.

The bill further makes various amendments to project-specific transitional exceptions contained in the Reform Act. Among these amendments is a clarification that bonds authorized to be issued in excess of the $150 million limitation on outstanding nonhospital bonds for section 501(c)(3) organizations under the project-specific transitional exceptions are in addition to any such bonds authorized under a generic transitional exception to the Reform Act (Reform Act sec. 1313(b)). Further, issuers may elect which exception to apply first—the project-specific exception or the generic exception. All transitioned bonds count toward the $150 million limit in determining the amount of additional bonds from which a section 501(c)(3) organization may benefit in the future.

XIV. Trust and Estates; Unearned Income of Certain Minor Children; Generation-Skipping Transfer Tax (Sec. 114 of the Bill)

A. Income Taxation of Trusts and Estates

1. Grantor treated as holding any power or interest of grantor's spouse (sec. 114(a) of the bill, sec. 1401 of the Reform Act, and sec. 672 of the Code)

Present Law

Under present law, the grantor of a trust is treated as the owner of the trust assets if the grantor retained certain powers or interests over all or a portion of the trust (sec. 671-678). In such a case, the income and deductions of that portion are taxed directly to the grantor. In addition, the grantor is treated as the owner of a trust if the trust has made certain loans to the grantor of the trust.

The grantor is treated as holding all powers and interests of the grantor's spouse if the grantor's spouse is living with the grantor at the time of creation of such interests and powers.

Explanation of Provision

The bill provides that the grantor will be treated as holding any power or interest that was held by an individual either (1) who was the grantor's spouse at the time that the power or interest was created or (2) who became the grantor's spouse subsequent to the creation of that power or interest. For this purpose, individuals are not considered married if they are legally separated under a decree of divorce or of separate maintenance. In addition, the grantor is treated as the owner of a trust where the trust makes certain loans to the grantor's spouse.

2. Limitations to reversionary interest rule exceptions (sec. 114(b) of the bill, sec. 1402 of the Reform Act, and sec. 673 of the Code)

Present Law

The grantor is treated as the owner of the trust property were the grantor or the grantor's spouse has a reversionary interest whose value is more than 5 percent of the value of the trust at the time of the inception of the trust.

Explanation of Provision

The bill provides that, in determining whether an reversionary interest has a value in excess of 5 percent of the trust, it will be assumed that any discretionary powers are exercised in such a way as to maximize the value of the reversionary interest. In addition, the bill reenacts a provision of prior law which provides rules for postponements of the date of a reversionary interest. This provision was deleted by the Act, but is necessary where the date of the reversionary interest is after the life of an individual and that date is later postponed.

3. Taxable year of trusts (sec. 114(c) of the bill and sec. 1403 of the Reform Act)

Present Law

Trusts are required to use a calendar year as their taxable year, effective for taxable years beginning after December 31, 1986. The taxable income of any beneficiary of a trust that is attributable to the trust's short taxable year arising from a required change of its taxable year to a calendar year is to be included in the beneficiary's income over a four year period beginning with the year of change.

Explanation of Provision

The bill provides that the four year spread from a required change of a taxable year also is available to beneficiaries of charitable remainder trusts (described in sec. 664).

4. Estimated taxes of trusts and estates (sec. 114(d) of the bill, sec. 1404 of the Reform Act, and sec. 6654 of the Code)

Present Law

Under present law, trusts, as well as estates for any taxable year ending 2 or more years after the date of the decedent's death, are required to pay estimated taxes in the same manner as individuals. In addition, the trustee may elect, in substance, to distribute any excess estimated payments to the trust beneficiaries if the trustee so elects within 65 days of the close of the trust's taxable year on the trust's tax return for that year.

Explanation of Provision

The bill provides that the individual estimated tax provisions do not apply to a trust subject to tax under section 511 or to any private foundation.[1] In addition, the bill clarifies that the election to distribute excess estimated tax payments to beneficiaries need not be made on the tax return for the trust for the preceding year, but may be made in a manner prescribed by the Secretary of the Treasury.

---

[1] See section 115(h) of the bill, clarifying the application of the corporate estimated tax requirements to these organizations.

B. Taxation of Unearned Income of Minor Children (Sec. 114(e) of the bill, sec. 1411 of the Reform Act, and secs. 1 and 59 of the Code)

Present Law

The unearned income of a child under age 14 in excess of $1,000 is taxed to the child at the highest marginal rate of the child's parents. This tax is determined by calculating the additional tax that the parents would pay if the parents' income included the unearned income of the child in excess of $1,000. In making this calculation, the amount of the parents' deductions and credits are not affected by the inclusion of any of the child's unearned income in the parents' income. The Secretary of the Treasury is to issue regulations providing for the application of these rules were the minor child or his parents is subject to the alternative minimum tax.

Where an individual transfers appreciated property to a trust and the trust disposes of such property within 2 years of the transfer, the tax on the built-in gain at the time of the transfer to the trust is determined at the highest marginal rate of the transferor for the year of sale (sec. 644).

Explanation of Provision

Computation of child's tax where parents' rates are used to determine tax of trust

The bill provides that, where parents whose marginal tax brackets are being used to determine both the income tax of a trust under section 644 and income tax of their minor children under section 1(i), the tax of the trust is determined first without regard to the income of the minor child and then the tax of the minor child is to be determined second by including the gain of the trust which is taxable under section 644 in the income of the parent. The bill also provides that the determination of the tax of the child does not affect that amount of any "exclusion," as well as any deduction or credit, of the parents.

Alternative minimum tax

The bill also provides that the alternative minimum tax imposed on the net unearned minimum taxable income of a child under 14 years of age will not be less than the alternative minimum tax which would have been imposed on the parents had that income been included in the parents' alternative minimum taxable income. The amount of minimum tax which would have been imposed on the parents is computed by including the child's net unearned minimum taxable income in the alternative minimum taxable income of the parents, and by increasing the parents' regular tax by the amount of the child's regular tax imposed on the net unearned income of the child. For this purpose, net unearned minimum taxable income means net unearned income (i.e., unearned income in excess of $1,000) computed by taking into account the preferences and adjustments provided in sections 56, 57 and 58.

For example, assume that the child's net unearned income (as defined in section 1(i)(4)) is $10,000 and the unearned minimum taxable income (as defined in section 59(j)(3) as added by the bill) is $20,000, by reason of the child having $10,000 of tax-exempt interest on newly issued private activity bonds. Assume that the parent are subject to the alternative minimum tax for the taxable year and that the parents' marginal rate for purposes of the regular tax is 28 percent. Under the rules of section 1(i), the child's regular tax on the net unearned income is $2,800. The child is not subject to the alternative minimum tax (determined without regard to this provision) by reason of the $30,000 exemption amount. Under the bill, the child's minimum tax will be $1,400 (21 percent of $20,000 ($4,200) less 28 percent of $10,000 ($2,800)). If, however, the parents would not have been subject to the alternative minimum tax (taking into account the net unearned minimum taxable income and the regular tax of the child) because their regular tax exceeded their tentative minimum tax, no minimum tax would be imposed on the child.

C. Generation-Skipping Transfer Tax

1. Overlap of direct skips and taxable termination and distributions (sec. 114(f)(3) of the bill, sec. 1431 of the Reform Act, and sec. 2612 of the Code)

Present Law

A "direct skip" is defined as a transfer subject to estate or gift tax of an interest in property to a skip person. A "taxable termination" is defined as a termination of an interest in property held in trust if (1) there is no nonskip person who has an interest in the trust after the termination or (2) at no time after the termination may a distribution be made from that trust to a nonskip person. A "taxable distribution" is defined as a distribution from a trust to a skip person (other than a taxable termination or a direct skip).

Explanation of Provision

The bill provides that, where a transfer meets the definitions of a direct skip and a taxable termination or distribution, the transaction will be treated as a direct skip. For example, where an individual transfers property into a trust that is to pay income to that individual for his life and, after that individual's death, to pay the remainder to that individual's grandchild, there is both a direct skip and a taxable termination under present law at the death of that individual. Under the bill, there is a direct skip from the individual to the individual's grandchild (and no taxable termination) at the time of that individual's death.

2. Treatment of charitable interests (sec. 114(f)(4) of the bill, sec. 1431 of the Reform Act, and sec. 2642 of the Code)

Present Law

Under present law, the amount of the generation-skipping transfer tax is determined by multiplying the amount involved by the "applicable rate." The applicable rate basically is the top Federal estate tax rate multiplied by the proportion of the property in the trust that is subject to tax, determined at the time the trust is established. The present value of charitable interests are deducted in determining the amount of the trust that is subject to tax.[2] The effect of deducting the present value of charitable interest in determining the applicable rate is to exempt property passing to a noncharitable person from the generation-skipping transfer tax, even if the charitable interest has expired at the time of the imposition of the generation-skipping transfer tax. For example, where property is placed in trust to pay an annuity to charity for the life of an individual, A, with the remainder to go to the transferor's grandchild, the amount of the generation-skipping transfer tax imposed at the death of A is reduced by the charity's annuity interest even though charity no longer has any interest in the trust.

---

[2] Technically, the "applicable rate" is the product of the maximum Federal estate tax rate and the "inclusion ratio." The "inclusion ratio" is the excess of 1 over the "applicable fraction." The "applicable fraction" is a fraction the numerator of which is the portion of the $1 million exemption allowed each individual that is allocated to this transfer and the denominator of which is the value of the property transferred to the generation-skipping trust reduced by (1) any Federal and State estate or death taxes recovered from the trust and (2) a charitable deduction for the value of any charitable interest in the trust at that time.

Explanation of Provision

The bill deletes the provision that removes the value of any charitable interests in determining the "applicable rate." Thus, in the case described above, the amount of the generation-skipping transfer tax will be determined by reference to the value of net assets placed in trust which is not sheltered by any of the $1 million exemption allocated to the trust.

Nonetheless, in order to insure that no generation-skipping transfer tax is imposed on property actually passing to charity, the bill provides that the amount that would be subject to a generation-skipping transfer tax is reduced by the value of any charitable interests at the time the generation-skipping tax is imposed. For example, where property is placed in a trust which is to pay an annuity to the transferor's child for life, then an annuity to the transferor's grandchild for life, with the remainder to go to charity at the grandchild's death, the amount subject to the generation-skipping transfer tax at the child's death is reduced by the present value of the charitable remainder interest determined as of the child's death.

These changes are effective for transfers made after June 10, 1987.

3. Special rule for determination of inclusion ratio where inter vivos transfers are includible in transferor's gross estate (sec. 114(f)(5) of the bill, sec. 1431 of the Reform Act, and sec. 2642 of the Code)

Present Law

The inclusion ratio is used to establish the rate of tax which is imposed on the generation-skipping transfer. It is the ratio the numerator of which is the amount of the $1 million exemption allowed to every individual that the transferor has allocated to a particular transfer and the denominator of which is the value of the property transferred to the trust reduced by any Federal or State death taxes recovered from the trust and the present value of any charitable interests in the trust.[3] Where any of the $1 million exemption is allocated to property transferred at or after the death of the transferor, the value of the property is its value for Federal estate tax purposes. Where any of the $1 million exemption is allocated on a timely filed gift tax return, the value of the property is its value for Federal gift tax purposes. Where any of the $1 million is allocated during the lifetime of the transferor but not on a timely filed gift tax return, the value of the property is determined at the time that the allocation is filed with the Internal Revenue Service.

---

[3] The bill removes the allowance of the charitable deduction for purposes of determining the inclusion ratio and allows a separate charitable deduction in computing the amount subject to the generation-skipping transfer tax.

Explanation of Provision

The bill provides that any allocation of any portion of the transferor's $1 million exemption to property that is transferred by the transferor during his lifetime, but would be includible in the transferor's gross estate (other than pursuant to sec. 2035) is not effective until the death of the transferor and the value of property for purposes of determining the inclusion ratio shall be its value for Federal estate tax purposes. Where any such property is subsequently transferred in such a manner that it would not be includible in the gross estate of the transferor (e.g., where the property is distributed by a trust to the transferor's grandchild), the distributions to skip persons are treated as direct skips, any allocation of the $1 million exemption is effective at that time, and the value of the property is its value at that time.

4. Definition of skip person involving trusts (sec. 114(f)(6) of the bill, sec. 1431 of the Reform Act, and sec. 2613 of the Code)

Present Law

Under present law, a "skip person" is defined to mean either (1) a person assigned to a generation that is two or more generations below that of the transferor or (2) a trust all the interests of which are held by such persons and at no time can make distributions to persons assigned to a generation less than two generations below that of the transferor (sec. 2613(a)). Also under present law, a trust generally is a person (sec. 7701(a)(1)).

If an estate, trust, partnership, corporation, or other entity has an interest in property, each individual having a beneficial interest in such entity is treated as having an interest in that property and is assigned to a generation under normal generation assignment rules consistent with that beneficial interest (sec. 2651(e)(2)).

Explanation of Provision

The bill clarifies the definition of a "skip person" by providing that a skip person must be a "natural person" whose generation assignment is two or more generations below that of the transferor (i.e., category (1), above). In addition, the bill provides that the determination of whether a trust is a "skip person" (i.e., category (2), above) is to be determined without regard to the entity look-through rules as they apply to trusts.

5. Disregard of support obligations as an interest (sec. 114(f)(7) of the bill, sec. 1431 of the Reform Act, and sec. 2652 of the Code)

Present Law

In order to determine whether there is a taxable termination (sec. 2612(a)), whether property is transferred to a skip person (sec. 2612(c)), and whether property qualifies for the $2 million exemption for transfers to grandchildren, it is necessary to determine which persons have an "interest" in the trust. A person generally is treated as having an interest held in trust if that person has a right (other than a future right) to receive income or corpus from a trust or is a permissible current recipient of income or corpus from the trust.

Description of Provision

The bill provides that any income or corpus of the trust that may be used to satisfy any obligation of support arising by reason of State law is to be be disregarded in determining whether a person has an interest in a trust, unless the trust instrument expressly provides that the trust assets may be used to discharge an obligation of support. Thus, a parent generally is not treated as having an interest in a trust or trust equivalent by reason of any powers that the parent may have under the State law comparable to the Uniform Gifts to Minors Act, or that the parent may have as a guardian for a child of the parent. On the other hand, a parent would be treated as having an interest in the trust if the trust instrument provided that the trust assets would be used to discharge the support obligations of that parent.

6. Taxation of multiple skips (sec. 114(f)(8) of the bill, sec. 1431 of the Reform Act, and sec. 2653 of the Code)

Present Law

Under present law, there is no generation-skipping transfer tax on what otherwise would be a direct skip where property is transferred from the transferor to the grandchild of the transferor or a trust for the benefit of such a grandchild if the parent of the grandchild is deceased at the time of the transfer (sec. 2612(c)). This is accomplished by deeming the generation assignment of the grandchild to "step up" to the generation of the child.

Also under present law, where property held in trust has been the subject of a generation-skipping transfer tax and the property remains in trust, the transferor of the property remaining in trust for purposes of subsequent applications of the generation-skipping transfer tax is deemed to be in the generation one higher than the generation of the beneficiary or beneficiaries with the highest generation. In effect, the generation of the transferor "drops down" to one generation older than that of the eldest beneficiaries of the trust. There is no "drop down" of the transferor where the property is exempt from the generation skipping tax by reason of the predeceased child exception of section 2612(c). Thus, if property is transferred by a grandparent to a trust for the exclusive benefit of the transferor's grandchild, distributions from the trust to the grandchild would be taxable distributions even though the grandchild's parents were deceased when the trust was created.

Explanation of Provision

The bill provides that the generation "drop-down" rule of section 2653(a) applies where there would have been a generation-skipping transfer but for the predeceased child rule of section 2612(c). Thus, where a grandparent transfers property to a trust which is to pay income to the grandparent's grandchild for life, distributions to the grandchild would not be taxable distributions if the grandchildren's parents were deceased at the time of the transfer to the trust.

7. Certain interests disregarded (sec. 114(f)(9) of the bill, sec. 1431 of the Reform Act, and sec. 2652(c)(2) of the Code)

Present Law

The determination of whether a trust is a generation-skipping trust depends upon whether a beneficiary has an "interest" in the trust. Under present law, a person generally has an interest in property if that person has a right (other than a future right) to receive income or corpus from the trust or is a permissible current recipient of income or corpus from the trust. Nonetheless, present law provides that an interest that is used primarily to postpone or avoid the generation-skipping transfer tax is disregarded in applying the generation-skipping transfer tax.

Explanation of Provision

The bill clarifies the rule of present law that disregards interests primarily used to postpone or avoid the generation-skipping transfer tax by removing any indication that the interest to be disregarded must be nominal and by providing that the rule applies if the primary purpose of the interest is to avoid any generation-skipping transfer tax. For example, if a transferor placed property in trust which is to pay income to a great grandchild for a relatively short period, then income to a grandchild for life, with remainder going back to a great grandchild, in order to avoid a second imposition of the generation-skipping transfer tax, the income interest of the great grandchild would be disregarded so that there would be a generation-skipping transfer tax at the death of the grandchild. That interest would be disregarded even though distributions to the grandchild and great grandchild are taxable distributions under present law.

8. Definition of transferor (sec. 114(f)(10) of the bill, sec. 1431 of the Reform Act, and sec. 2652 of the Code)

Present Law

The term "transferor" is defined to mean the decedent, in the case of a transfer of a kind subject to the Federal estate tax, or the donor, in the case of a transfer of a kind subject to the Federal gift tax. In some cases, it is possible for property to be subject to Federal estate or gift tax even though there is no transfer of such property under local law at such time. For example, in the case of a trust which is to pay income to the transferor for life, then income to the transferor's child for life, remainder to the transferor's grandchild, the property is includible in the gross estate of the transferor, even though there is no transfer of the trust assets under local law at the time of the transferor's death.

Explanation of Provision

The bill clarifies the definition of "transferor" by providing that a person is treated as the transferor of any property included in the gross estate of that person or which that person has made a gift. Thus, a person can be a transferor even though there is not a transfer of property under local law. The transferor is treated as transferring any property with respect to which that person is the transferor.

9. Regulatory authority to prescribe rules dealing with trust equivalents (sec. 114(f)(11) of the bill, sec. 1431 of the Reform Act, and sec. 2663 of the Code)

Present Law

The generation-skipping transfer tax is imposed on generation-skipping trusts. For this purpose, a trust is any arrangement (other than an estate) which has substantially the same effect as a trust. Examples of such arrangements include life estates and remainders, estates for years, and insurance and annuity contracts.

Explanation of Provision

The bill provides the Secretary of the Treasury with authority to prescribe regulations modifying the generation-skipping transfer tax rules generally applicable to trusts in the case of trust equivalents. For example, where the generation-skipping arrangement is in the form of an insurance or annuity contract, it is possible that the Secretary of the Treasury may exercise the authority granted by this section of the bill to provide that the beneficiary of the insurance or annuity contract pay any generation-skipping transfer tax.

10. Clarification of inclusion ratio where all transfers to the generation-skipping trust qualify for the gift tax exclusions (sec. 114(f)(12) of the bill, sec. 1431 of the Reform Act, and sec. 2642 of the Code)

Present Law

In the case of direct skips, the inclusion ratio with respect to transfers which qualify for the annual $10,000 gift tax exclusion (under section 2503(b)) or the gift tax exclusion for medical and educational costs (under sec. 2503(c)) is zero. In the case of taxable terminations and taxable distributions from a generation-skipping trust, the determination of the inclusion ratio generally is not affected by such nontaxable transfers. Nonetheless, in the case of any nontaxable transfer to a generation-skipping trust which is the first transfer to the trust, the inclusion ratio for that trust is zero.

Explanation of Provision

The bill clarifies that a generation-skipping trust has an inclusion ratio of zero where the initial transfer to the trust is a wholly nontaxable gift. For example, assume that an individual transfers property which wholly qualifies for the $10,000 annual gift tax exclusion to a newly created generation-skipping trust in 1988. The bill clarifies that the inclusion ratio applicable to that trust is zero. Now assume that the individual transfers additional property which wholly qualifies for the $10,000 annual gift tax inclusion to the trust in 1989. Since the transfer in 1989 is not taken into account in determining the inclusion ratio under section 2642(c)(2)(A), the inclusion ratio of the trust after that transfer remains zero.

11. Generation assignment of governmental entities (sec. 114(f)(13) of the bill, sec. 1431 of the Reform Act, and sec. 2651(e)(3) of the Code)

Present Law

In general, persons who are related to the transferor are assigned to a generation based upon their relationship to the transferor. Persons who are not related to the transferor are assigned to a generation based upon the difference in age between that person and the transferor. Charitable organizations (described in secs. 511(a)(2) and (b)(2)) are assigned to the same generation as that of the transferor.

Explanation of Provision

The bill provides that any governmental entity is assigned to the same generation as that of the transferor. The rule applies to all governmental entities, including the United Stated Government, the government of any State, and the government of any foreign country.

12. Basis of property after a taxable termination (sec. 114(f)(14) of the bill, sec. 1431 of the Reform Act, and sec. 2654 of the Code)

Present Law

Where property is subject to a generation-skipping transfer tax, the basis of the property immediately after the generation-skipping transfer tax generally is its basis immediately before the imposition of the generation-skipping transfer tax increased (but not in excess of the property's fair market value at such time) by the portion of the generation-skipping transfer tax attributable to any appreciation in the property at such time. Nonetheless, where property that is entirely subject to a generation-skipping transfer tax at the same time as and as a result of the death of an individual, the basis of the property immediately after the imposition of the generation-skipping transfer tax generally is its fair market value at such time. Where only a portion of the property is subject to the generation-skipping transfer tax (because the inclusion ratio is less than 1), any increase in basis to the property's fair market value basically is limited to the portion of the property subject to the generation-skipping transfer tax (i.e., the amount of appreciation in the property multiplied by the inclusion ratio).

Explanation of Provision

The bill provides that where the basis of property that has been subject to a generation-skipping transfer tax is to be determined by reference to its fair market value (because the generation-skipping transfer tax occurs at the same time as and as a result of the death of an individual) and the inclusion ratio is less than 1, any decrease in basis (as well as any increase in basis) is limited by the decrease in the 78value of such property multiplied by the inclusion ratio.

13. Treatment of single trust as multiple trusts (sec. 114(f)(15) of the bill, sec. 1431 of the Reform Act, and sec. 2654 of the Code)

Present Law

The generation-skipping transfer tax is imposed on direct skips and taxable terminations and taxable distributions from a generation-skipping trust. The impact of the generation-skipping transfer tax sometimes depends upon whether assets are transferred in one trust or in more than one trust. For example, where transfers that qualify for the $10,000 annual exclusion are made to a generation-skipping trust that has an inclusion ratio greater than zero, some or all of such transfers may be subject to a generation-skipping transfer tax as a taxable termination or taxable distribution, even though such transfers would not be subject to the generation-skipping transfer tax if they were made to a separate trust.

Explanation of Provision

The bill provides that a single trust may not be treated as two separate trusts for purposes of the generation-skipping transfer tax.

14. Effective date of the revised generation-skipping transfer tax (sec. 114(g)(1) and (2) of the bill and sec. 1433 of the Reform Act)

Present Law

The revised generation-skipping transfer tax generally applies to transfers made after the date of enactment of the Reform Act (October 22, 1986). In addition, the revised generation skipping transfer tax applied to inter vivos transfers made after September 25, 1985.

The generation-skipping transfer tax does not apply, however, to—

(1) inter vivos transfers made before September 26, 1985,

(2) trusts that were irrevocable before September 26, 1985, except for additions of corpus to such trusts after September 25, 1985,

(3) testamentary transfers made pursuant to will in existence before the date of enactment of the Reform Act (October 22, 1986) if the decedent died before January 1, 1987, and

(4) transfers under a trust to the extent that such trust consists of property included in the gross estate of the decedent or which are direct skips which occur by reason of the death of any decedent if the decedent was incompetent on the date of enactment of the Reform Act (October 22, 1986) and at all times thereafter until death.

Explanation of Provision

The bill clarifies that the grandfather of irrevocable trusts created before September 25, 1985, applies whether or not income derived from corpus contributions before September 26, 1985, is distributed or accumulated. The bill also provides that the grandfather of transfers made pursuant to wills in existence on the date of enactment of the Reform Act (October 22, 1986) if the decedent dies before January 1, 1987, also applies to transfers pursuant to revocable trusts which were in existence on the date of enactment of the Reform Act (October 22, 1986) if the decedent dies before January 1, 1987. Finally, the bill clarifies that the decedent must have been incompetent on Septerber 25, 1985, and at all times thereafter until death, in order for direct skips or transfers of assets includible in the decedent's gross estate to be exempt from generation-skipping transfer taxes.

15. $2 million exemption (sec. 114(g)(3) of the bill and sec. 1433 of the Reform Act)

Present Law

The revised generation-skipping transfer tax on direct skips does not apply to transfers before January 1, 1990, from a transferor to a grandchild of the transferor to the extent that the aggregate transfers from that transferor to that grandchild do not exceed $2 million. An election may be made to treat inter vivos and testamentary contingent transfers in trusts for the benefit of a grandchild as direct skips if (1) the transfers occur before the date of enactment of the Reform Act (October 22, 1986), and (2) the transfers would be direct skips except for the fact that the trust instrument provides that, if the grandchild dies before vesting of the interest transferred, the interest is transferred to the grandchild's heirs (rather than the grandchild's estate). Transfers treated as direct skips as a result of this election are subject to Federal gift and estate tax on the grandchild's death in the same manner as if the contingent gift over had been to the grandchild's estate.

Explanation of Provision

The bill clarifies the application of the $2 million exemption in three respects. First, the bill clarifies that a transfer to a trust is treated as a transfer to a grandchild if (1) no amount may be distributed to any person other than that grandchild during the life of that grandchild, (2) the assets will be includible in the gross estate of the grandchild if the grandchild dies before the termination of the trust, and (3) all of the income of the trust after the child has reached age 21 must be distributed to the grandchild not less often than annually.

Second, the bill clarifies that trusts which are eligible for the $2 million exemption are treated as if that trust had been subject to the generation-skipping transfer tax and, consequently, that distributions out of a trust to such a grandchild are not treated as taxable distributions.

Third, the bill amends the special rules applicable to transfers in trust before the date of enactment of the Reform Act (sec. 1433(d) of that Act) by (a) clarifying that transfers to such trusts are treated as transfers to a grandchild (and, therefore, eligible for the $2 million exclusion) and (b) providing that the executor of the grandchild can recover the additional estate taxes imposed upon the estate of the grandchild by reason of the election from that person or persons receiving the property unless the will of the grandchild provides otherwise.

XV. Compliance and Tax Administration Provisions (Sec. 115 of the Bill)

1. Nominee reporting by partnerships (sec. 115(a) of the bill, sec. 1501 of the Reform Act, and sec. 6724(d)(2)(B) of the Code)

Present Law

Present law requires that any person holding an interest in a partnership as a nominee for another person must furnish to the partnership the name and address of that other person (along with any additional information required by regulations) (Code sec. 6031(c)). Failure by the nominee to provide this information to the partnership is not subject to the general penalty for failure to file information reports as required.

Explanation of Provision

The bill provides that a nominee's failure to supply the required information to the partnership is subject to the general penalty for failure to furnish payee statements (sec. 6722). This penalty is $50 per failure, up to a maximum of $100,000 per calendar year.

2. Negligence and fraud penalties (sec. 115(b) of the bill, sec. 1503 of the Reform Act, and secs. 6013(b)(5), 6601(e), and 6653 of the Code)

Present Law

Taxpayers are subject to penalties if any part of an underpayment of tax is due to negligence or fraud (Code sec. 6653). Both of these penalties have two components. The first component of each penalty is the basic penalty (5 percent of the entire understatement in the case of negligence, 75 percent of the portion attributable to fraud in the case of fraud). The second component of each penalty is an amount equal to one-half the interest payable on the portion of the underpayment attributable to either negligence or fraud (as the case may be), for the period beginning on the last day prescribed for payment of the underpayment (without regard to any extension) and ending on the date of the assessment of the tax (or the date of payment of the tax if that date is earlier). Interest on the negligence and fraud penalties generally begins on the date these penalties are assessed, rather than the last date prescribed for filing the return to which the penalty relates.

Explanation of Provision

The bill repeals the second, time-sensitive components of both the negligence and fraud penalties. The bill instead imposes interest on these penalties from the last date prescribed for filing the return to which the penalty relates. The bill also improves the coordination of these penalties with the provision permitting a couple to file a joint return after filing a separate return (Code sec. 6013(b)).

These provisions apply to returns the due date for which (determined without regard to extensions) is after December 31, 1987.

3. Penalty for substantial understatement of tax liability (sec. 115(c) of the bill and sec. 1504 of the Reform Act)

Present Law

A taxpayer who substantially understates income tax for any taxable year must pay a penalty (Code sec. 6661). The Tax Reform Act of 1986 provided that this penalty is to be 20 percent of the amount of the underpayment of tax attributable to the understatement. This was effective for returns the due date of which (determined without regard to extensions) is after December 31, 1986.

After considering the Reform Act, Congress considered the Omnibus Budget Reconciliation Act of 1986 (P.L. 99-509). That Act[1] increased this penalty to 25 percent of the underpayment, effective for penalties assessed after the date of enactment of that Act. Although Congress considered the Reform Act prior to considering the Omnibus Budget Reconciliation Act, the Omnibus Budget Reconciliation Act was enacted one day before the date of enactment of the 1986 Act.[2]

Explanation of Provision

The bill provides that the increase in the substantial understatement penalty to 25 percent made by the Omnibus Budget Reconciliation Act of 1986 shall take effect as if the Tax Reform Act of 1986 were enacted on the day before the date of enactment of the Omnibus Budget Reconciliation Act of 1986.

4. Differential interest rate (sec. 115(d) of the bill, sec. 1511 of the Reform Act, and sec. 6621 of the Code)

Present Law

The interest rate that taxpayers pay to the Treasury on underpayments of tax is one percentage point higher than the interest rate the Treasury pays to taxpayers on overpayments of tax.

Explanation of Provision

The bill corrects several cross-references to the provisions utilized to determine these rates.

---

[1] *See* sec. 8002 of the Omnibus Budget Reconciliation Act of 1986.

[2] The Omnibus Budget Reconciliation Act of 1986 was enacted on October 21, 1986; the 1986 Act was enacted on October 22, 1986.

5. Information reporting by brokers (sec. 115(e) of the bill, sec. 1521 of the Reform Act, and sec. 6045 of the Code)

Present Law

Persons doing business as a broker must report on specified types of transactions they effect for customers. Generally, reporting is required on sales of securities, commodities, regulated futures contracts, precious metals, and real estate.

Explanation of Provision

The bill provides that a person shall not be treated as a broker with respect to activities consisting of managing a farm on behalf of another person. This exempts farm managers from the requirement of filing a Form 1099-B with respect to their farm management activities. This information must be filed by these farm managers on a Schedule F, where it is provided in a more useful format. Consequently, filing this information on a Form 1099-B is duplicative. This provision is effective as if included in the Tax Equity and Fiscal Responsibility Act of 1982 (which generally imposed these information reporting requirements).

The bill also makes it unlawful for any real estate broker (who is generally defined as the person responsible for closing the real estate transaction) to charge separately any customer for complying with the information reporting requirements with respect to real estate transactions. This provision is effective on the date of enactment of the bill.

6. Information reporting on persons receiving contracts from certain Federal agencies (sec. 115(f) of the bill, sec. 1522 of the Reform Act, and sec. 6050M of the Code)

Present Law

Present law requires that the head of each Federal executive agency file an information return with the IRS indicating the name, address, and taxpayer identification number of each person with which the agency enters into a contract. The agency must also report any additional information required under Treasury regulations. There is no exception from this information reporting in present law for contracts involving national security, confidential law enforcement, or foreign counterintelligence activities.

Explanation of Provision

The bill excepts specified types of contracts from the general information reporting requirements applicable to Federal executive agencies, and makes those types of contracts subject to a different form of information reporting.

There are two types of contracts between a Federal executive agency and another person that are subject to these special rules. The first is a contract where either the fact of the existence of the contract or the subject matter of the contract has been classified. This is accomplished by designating and clearly marking or clearly representing, pursuant to the provisions of Federal law or an Executive order,[3] that the contract or the subject matter of the contract requires a specific degree of protection against unauthorized disclosure for reasons of national security. The second type of contract subject to the special rules is a contract involving a confidential law enforcement or foreign counterintelligence activity. In order to be eligible for these special rules, the head of the Federal executive agency (or his designee) must determine in writing that filing the information return generally required of Federal executive agencies would interfere with the effective conduct of a confidential law enforcement or foreign counterintelligence activity. This determination must be made pursuant to regulations issued by the Federal executive agency making the determination. This second type of contract involves primarily undercover operations (including sites for undercover operations) and informants.

These two types of contracts are subject to special information reporting requirements, and are exempted from the general information reporting requirements of section 6050M. The special information reporting requirements are that the IRS must first request that the Federal executive agency acknowledge whether that agency has entered into a contract with a particular person, who must be identified in the IRS request. The Federal executive agency must in response acknowledge whether it has entered into a contract with the specified person. If it has, it must provide to the IRS with respect to that person the information required to be reported under section 6050M. In addition, the agency must provide whatever additional information the agency and the Treasury agree is appropriate. The term "person" has the meaning given in section 7701(a)(1).

It is contemplated that the information provided by Federal executive agencies to the IRS under these special rules might need to be provided only to certain IRS employees, such as those with security clearances. If this is necessary, it is also contemplated that the Federal executive agencies will cooperate with the IRS in expeditiously obtaining clearance for the IRS employees.

This provision is effective as if included in the 1986 Act (i.e., on January 1, 1987).

7. Information reporting on royalties (sec. 115(g) of the bill, sec. 1523 of the Reform Act, and sec. 6676 of the Code)

Present Law

Persons who make payments of royalties aggregating $10 or more to any person in a calendar year must provide an information report on the royalty payments to the IRS (as well as provide a copy to the payee) (Code sec. 6050N).

Explanation of Provision

The bill deletes the requirement that payors of royalties must exercise due diligence in obtaining the taxpayer identification numbers of payees of royalties.

---

[3] Executive Order 12356 is the currently effective Executive order prescribing a uniform system for classifying, declassifying, and safeguarding national security information (47 Federal Register 14874; April 6, 1982).

This requirement is eliminated because of its interaction with the requirements of backup withholding (Code sec. 3406). Prior to the bill, a payor of royalties was required to exercise due diligence in obtaining a taxpayer identification number; otherwise the payor was subject to a penalty for failure to exercise due diligence. This was parallel to the treatment of payors of interest and dividends. Payors of interest and dividends are required to impose backup withholding if the payee does not certify that the taxpayer identification number is correct. Unlike payors of interest and dividends, payors of royalties were not permitted to impose backup withholding under these circumstances. The requirement that payors of royalties exercise due diligence in obtaining taxpayer identification numbers is consequently repealed to eliminate this nonparallel treatment of royalties. After repeal, payors of royalties are treated similarly to payors of other reportable payments subject to backup withholding (other than interest and dividend payors).

8. Estimated tax requirements for tax-exempt organizations (sec. 115(h) of the bill, sec. 1542 of the Reform Act, and sec. 6154 of the Code)

Present Law

Present law, as amended by the 1986 Act, requires that estimated tax payments of the excise tax on the net investment income of private foundations and the tax on unrelated business income of tax-exempt organizations be made in accordance with the rules generally applicable to corporate estimated tax payments.

Explanation of Provision

The bill clarifies that the corporate estimated tax provisions (secs. 6154 and 6655) apply to all payments of estimated tax by private foundations. These provisions apply whether the private foundation is organized as a trust or as a corporation, and whether or not the foundation is tax-exempt. Thus, for example, a taxable private foundation organized as a trust will be required to make estimated tax payments of both the excise tax under section 4940(b) and any income tax under subtitle A in accordance with the rules of sections 6154 and 6655. The individual estimated tax provisions will not apply to any private foundation or tax-exempt trust.[4]

The bill further provides that in the case of a tax-exempt organization or a private foundation, the period of underpayment of estimated tax runs to the 15th day of the fifth month following the close of the taxable year (i.e., the due date of the unrelated business income tax return).

---

[4] *See* also section 114(d) of the bill.

9. Awards of attorney's fees in tax cases (sec. 115(i) of the bill, sec. 1551 of the Reform Act, and sec. 7430(c)(2)(A) of the Code)

Present Law

The prevailing party (other than the United States) in tax cases may be eligible for an award of attorney's fees if it can establish that the position of the United States was not substantially justified and if other conditions are satisfied, which are generally parallel to the requirements for an award of attorney's fees under the Equal Access to Justice Act (which generally applies in non-tax cases).

Explanation of Provision

The bill clarifies two cross-references to provisions of the Equal Access to Justice Act. First, the bill clarifies that the rules of that Act relating to the time period within which a claim for attorney's fees must be made also apply to claims in tax cases. Second, the bill clarifies that the net worth limitations of that Act (rather than parallel provisions elsewhere in the United States Code) apply to prevailing parties in tax cases.

10. Salary of special trial judges (sec. 115(j) of the bill and sec. 1556 of the Reform Act)

Present Law

The salary of special trial judges of the Tax Court is 90 percent of the salary of judges of the Tax Court (Code sec. 7443A(d)(1)). The President's salary recommendations[5] may be construed to have reduced the salary of special trial judges below that 90-percent level.

Explanation of Provision

The bill provides that to the extent the President's salary recommendations are inconsistent with the 90-percent level specified in the Code, the recommendations are not effective.

11. Retirement pay of Tax Court judges (sec. 115(k) of the bill, sec. 1557 of the Reform Act, and sec. 7447 of the Code)

Present Law

A Tax Court judge's retirement pay is based upon the judge's length of service as a judge. A judge who serves on the Tax Court at least 10 years receives full retirement pay; the retirement pay of a judge serving less than 10 years is proportionately reduced. Time served as a judge in recalled status after retirement does not count for purposes of computing the 10-year period.

---

[5] *The Budget of the United States Government, 1988, Recommendations for Executive, Legislative, and Judicial Salaries*, submitted to the Congress on January 5, 1987.

Explanation of Provision

The bill provides that service on a substantially full-time basis in recalled status after retirement is considered in computing the 10-year period. The provision applies for purposes of determining retirement pay paid after the date of enactment of the bill, regardless of when the services in recalled status after retirement were or are performed.

12. Suspension of statute of limitations during prolonged dispute over third-party records (sec. 115(l) of the bill, sec. 1561 of the Reform Act, and sec. 7609 of the Code)

Present Law

If a dispute between a third-party recordkeeper and the IRS is not resolved within six months after the IRS issues an administrative summons, the statute of limitations is suspended until the issue is resolved (sec. 7609(e)).

Explanation of Provision

The bill clarifies that this suspension of the statute of limitations encompasses disputes with all third-party recordkeepers listed in the statute, regardless of whether the summons does or does not identify the person with respect to whose liability the summons is issued.

13. Rescission of statutory notice of deficiency (sec. 115(m) of the bill, sec. 1562 of the Reform Act, and sec. 6212 of the Code)

Present Law

Where the IRS and the taxpayer mutually agree, a statutory notice of deficiency may be rescinded. Once the notice has been properly rescinded, it is treated as if it never existed.

Explanation of Provision

The bill clarifies that rescission of a statutory notice of deficiency does not affect any suspension of the running of any period of limitations during any period during which the rescinded notice was outstanding. For example, assume that six months remain to run on the statute of limitations with respect to a return when the IRS issues a statutory notice of deficiency. Issuance of this notice suspends the statute of limitations. If the IRS and the taxpayer agree to rescind the statutory notice, then as of the date the notice is rescinded, the statute of limitations again begins to run and (in this example) six months remains until the statute expires.

14. General requirement of return, statement, or list (sec. 115(n) of the bill and sec. 6011 of the Code)

Present Law

When required by regulations, any person liable for any tax or the collection thereof must make a return or statement in the manner required.

Explanation of Provision

The bill clarifies the language of the Code containing this requirement.

15. Certain refundable credits to be assessed under deficiency procedures (sec. 115(o) of the bill and sec. 6211 of the Code)

Present Law

Under present law, the deficiency procedures allowing taxpayers to litigate issues in the Tax Court relating to the earned income credit (sec. 32) and the credit for the certain payments of the gasoline and special fuels tax (sec. 34) may not apply.

Explanation of Provision

The bill provides that the Tax Court deficiency procedures apply to the credits allowable under sections 32 and 34, notwithstanding that the credits reduce the net tax to less than zero.

The provision applies to taxable years beginning after the date of enactment of this bill.

XVI. Exempt and Nonprofit Organizations (Sec. 116 of the Bill)

1. Title-holding companies (sec. 116(a) of the bill, secs. 1603 and 1878(e) of the Reform Act, and secs. 501(c)(25) and 514(c)(9) of the Code)

Present Law

In general

The Act provides a new category of tax-exempt organizations, consisting of certain corporations or trusts that are organized for the exclusive purposes of acquiring and holding title to real property, collecting income from such property, and remitting the income (less expenses) from such property to one or more specified categories of tax-exempt organizations that are shareholders of the corporation or beneficiaries of the trust (Code sec. 501(c)(25)). Such a title-holding company is entitled to tax-exempt status only if it has no more than 35 shareholders or beneficiaries and has only one class of stock or beneficial interest, and only if it meets certain other requirements.

Eligible shareholders or beneficiaries

Under the Act, the categories of tax-exempt organizations eligible to hold interests in a section 501(c)(25) title-holding company are (1) a qualified pension, profit-sharing, or stock bonus plan (sec. 401(a)); (2) a governmental pension plan (sec. 414(d)); (3) the United States, a State or political subdivision, or governmental agencies or instrumentalities; (4) tax-exempt charitable, educational, religious, or other organizations described in section 501(c)(3); and (5) other title-holding companies described in section 501(c)(25).

Rights of eligible shareholders or beneficiaries

To qualify under section 501(c)(25), the title-holding company is required to permit its shareholders or beneficiaries to (1) dismiss, after reasonable notice, the corporation's or trust's investment advisor by majority vote of the shareholders or beneficiaries; and (2) terminate their interest by (a) selling or exchanging their stock or beneficial interest (subject to Federal or state securities law) to any other eligible organization, as long as the sale of exchange does not increase the total number of shareholders or beneficiaries to more than 35, or (b) redeeming their stock or beneficial interest after providing 90 days' notice to the corporation or trust. The Act did not expressly provide a sanction for the failure of a title-holding company to satisfy the requirements relating to the rights of eligible shareholders or beneficiaries.

Unrelated business taxable income

Exempt organizations are subject to tax on any unrelated business taxable income, including income from debt-financed property. (An organization is not precluded from qualifying for tax-exempt status merely because it derives unrelated business taxable income, so long as the organization is not organized or operated for the primary purpose of carrying on an unrelated trade or business.) The term debt-financed property means any property held to produce income with respect to which there is acquisition indebtedness at any time during the taxable year, or during the 12 months prior to disposition if the property is disposed of during the taxable year (sec. 514(b)).

Under an exception to the debt-financed property rules, indebtedness incurred by certain tax-exempt organizations (i.e., qualified pension plans and certain tax-exempt educational organizations) as a result of the acquisition or improvement of real property is not considered acquisition indebtedness (sec. 514(c)(9)). The Act extended this exception to debt-financed real property held by a section 501(c)(25) title-holding company.

The Act also provides that an interest in a mortgage is not treated as an interest in real property for purposes of the debt-financed property rules in the case of real property held by a partnership (sec. 514(c)(9)(B)(vi)).

Explanation of Provision

Definition of real property

The bill clarifies the definition of permissible holdings of real property by a title-holding company by providing that, for purposes of section 501(c)(25), the term real property does not include any interest as a tenant in common (or similar interest) and does not include any indirect interest. This rule ensures a consistent application of the intent of section 501(c)(25) that a title-holding company is required to hold real property directly and cannot, for example, treat an interest in a partnership, trust, or other entity as an investment in real property.

The bill also provides that for purposes of section 501(c)(25), the term real property includes any personal property that is leased under, or in connection with, a lease of real property. This exception to the general rule that a section 501(c)(25) title-holding company may only hold real property applies only if the rent attributable to the leasing of such personal property (determined under the rules of sec. 856(d)(1)) for the taxable year does not exceed 15 percent of the total rent for the taxable year attributable to both the real and personal property under the lease.

Eligible shareholders or beneficiaries

In order to implement the 35-person limitation on shareholders or beneficiaries of a section 501(c)(25) organization, the bill deletes the provision of the Act that had defined an eligible shareholder or beneficiary in a title-holding company to include other section 501(c)(25) title-holding companies. In lieu of that rule, the bill provides that a corporation that is a qualified subsidiary of a section

501(c)(25) title-holding company is not to be treated as a separate corporation for Federal tax law purposes. In the case of such a qualified subsidiary, all assets, liabilities, and items of income, deduction, and credit of the qualified subsidiary are treated as assets, liabilities, and such items of the title-holding company.

Under the bill, the term qualified subsidiary means a corporation that, at all times while in existence, is wholly owned by the section 501(c)(25) title-holding company. If a qualified subsidiary subsequently ceases to satisfy the 100-percent stock ownership requirement, the qualified subsidiary is treated, immediately before the time it ceases to meet such ownership requirement, as a new corporation acquiring all of its assets and assuming all of its liabilities in exchange for its stock.

Rights of shareholders or beneficiaries

The bill expressly provides that a title-holding company is not entitled to tax-exempt status under section 501(c)(25) if it fails to permit its shareholders or beneficiaries to dismiss the organization's investment advisor or to terminate their interest in the corporation or trust in the manner specified in the statute.

Unrelated business taxable income

The bill modifies the exception to the unrelated business taxable income rules in the case of debt-financed real property owned by a section 501(c)(25) title-holding company to provide that the exception is not available in the case of a disqualified holder. (Of course, a title-holding company does not fail to qualify for tax-exempt status merely because its shareholders or beneficiaries have unrelated business income as a result of the operation of this rule.)

Thus, in computing the unrelated business taxable income of a disqualified holder of an interest in a title-holding company, the holder's pro rata share of the items of income that are treated as gross income derived from an unrelated trade or business (without regard to the exception for debt-financed real property) is taken into account as gross income of the disqualified holder derived from an unrelated trade or business. Further, the holder's pro rata share of the items of deductions allowable in computing unrelated business taxable income (without regard to the exception for debt-financed real property) also is taken into account as deductions in computing unrelated business taxable income. These items of income and deduction are taken into account for the taxable year of the holder in which (or with which) the taxable year of the title-holding company ends.

Under the bill, the term disqualified holder means any title-holding company shareholder or beneficiary other than either (1) an educational institution (described in sec. 170(b)(1)(A)(ii)) or its affiliated support organizations (described in sec. 509(a)(3)) or (2) a qualified pension trust (within the meaning of sec. 401(a)).

Under the bill, the rule excluding an interest in a mortgage from the definition of real property applies for all purposes under the exception for debt-financed real property, rather than solely in the case of real property held by a partnership.

XVII. Miscellaneous Provisions (Sec. 118 of the Bill)*

1. Tax-exempt entity leasing; definition of tax-exempt controlled entity (sec. 118(b)(2) of the bill, sec. 1802(a)(2) of the Reform Act, and sec. 168(h) of the Code)

Present Law

Under the Act, the term "tax-exempt controlled entity" does not include a corporation more than 50 percent of the stock in which is owned by a foreign person or entity. In addition, in the case of a corporation the stock of which is publicly traded, a tax-exempt entity's holdings are disregarded unless such entity owns at least five percent of the stock in the corporation (sec. 168(h)(6)(F)(iii)).

Explanation of Provision

The bill clarifies that the amendment applies as if enacted in the Tax Reform Act of 1984.

2. Accrual of interest on certain short-term obligations (sec. 118(c) of the bill, sec. 1803(a)(8) of the Reform Act, and sec. 1281 of the Code)

Present Law

Under section 1281 of the Code, certain taxpayers are required to include in income as interest for a taxable year that portion of the acquisition discount or original issue discount on a short-term obligation that is allocable to the portion of the year during which the taxpayer held the obligation. The Act clarified that taxpayers subject to the rule for mandatory accrual are required to include in income for a taxable year all amounts of interest, irrespective of whether the interest is stated or is in the form of discount. The amendment made by the Act applies to obligations acquired after September 27, 1985.

Explanation of Provision

The bill provides that the amendment made by the Act applies only to obligations acquired after December 31, 1985. It is understood that many of the taxpayers affected by the amendment made by the Act are small banks that, as a group, customarily file returns without extension. It is also understood that small banks may not have the capacity to develop the required information for both 1985 and 1986, in time for the banks to file their 1986 returns without extensions. The purpose of the change in effective date is to relieve these taxpayers of the administrative burden of identifying stated interest on short-term obligations acquired after September 27, 1985 and before January 1, 1986. For obligations acquired after December 31, 1985, taxpayers will be required to comply with the amendment made by the Act.

---

* *Note*: Section 117 of the bill contains clerical and conforming changes only.

3. Earnings and profits (sec. 118(d)(3) of the bill, sec. 1804 of the Reform Act, and sec. 312(b) of the Code)

Present Law

The Act clarified the effect on earnings and profits of a distribution of appreciated property.

Explanation of Provision

The bill provides that the rules relating to the distribution of appreciated property under section 312(b) do not apply to a distribution of a corporation's own obligation. Thus, earnings and profits will not be increased by reason of such a distribution.

4. Treatment of transferor corporation (sec. 118(d)(4) of the bill, sec. 1804 of the Reform Act, and secs. 361 and 355 of the Code)

Present Law

The Tax Reform Act of 1984 generally required that all property received by a corporation in a "C" reorganization be distributed. In addition, that Act provided that a corporation must recognize gain on the distribution of appreciated property to its shareholders in a nonliquidating distribution. The 1986 Act made a series of amendments to the reorganization provisions attempting to conform those provisions with changes made by the 1984 Act. However, numerous technical problems with the 1986 amendments have arisen. The bill responds to these technical problems with a complete revision of the 1986 amendments.

Explanation of Provision

Treatment of reorganization exchange.— The bill restores the provisions of section 361, relating to the nonrecognition treatment of an exchange pursuant to a plan of reorganization, as in effect prior to the amendments made by the 1986 Act. Thus, as under prior law, gain or loss will generally not be recognized to a corporation which exchanges property, in pursuance of the plan of reorganization, for stock and securities in another corporation a party to the reorganization. However, as under prior law, gain will be recognized to the extent the corporation receives property other than such stock or securities and does not distribute such other property pursuant to the plan of reorganization.[1]

The bill amends prior law by providing that transfers of property to creditors in satisfaction of the corporation's indebtedness in connection with the reorganization are treated as distributions pursuant to the plan of reorganization for this purpose.[2] The Secretary of the Treasury may prescribe regulations necessary to prevent tax avoidance by reason of this provision. This amendment is not intended to change in any way the definition of a reorganization within the meaning of section 368.

---

[1] This could occur, for example, where liabilities are assumed in a transaction to which section 357(b) or (c) applies.

[2] This overrules the holding in *Minnesota Tea Company v. Helvering*, 302 U.S. 609 (1938).

Treatment of distributions in reorganizations.—The bill also conforms the treatment of distributions of property by a corporation to its shareholders in pursuance of a plan of reorganization to the treatment of nonliquidating distributions (under section 311). Under the bill, the distributing corporation generally will recognize gain, but not loss, on the distribution of property in pursuance of the plan of reorganization. However, no gain will be recognized on the distribution of "qualified property". For this purpose, "qualified property" means (1) stock (or rights to acquire stock) in, or the obligation of, the distributing corporation and (2) stock (or rights to acquire stock) in, or the obligation of, another corporation which is a party to the reorganization and which were received by the distributing corporation in the exchange. The bill also provides that the transfer of qualified property by a corporation to its creditors in satisfaction of indebtedness is treated as a distribution pursuant to the plan of reorganization.[3]

Basis.—The bill clarifies that the basis of property received in an exchange to which section 361 applies, other than stock or securities in another corporation a party to the reorganization, is the fair market value of the property at the time of the transaction (pursuant to section 358(a)(2)). Thus the distributing corporation will recognize only post-acquisition gain on any taxable disposition of such property received pursuant to the plan of reorganization. Of course, the other corporation will recognize gain or loss on the transfer of its property under the usual tax principles governing the recognition of gain or loss.

Treatment of section 355 distributions.—Finally, the bill provides that the rules of section 311 shall apply to the distribution of property in a section 355 transaction which is not in pursuance to a plan of reorganization. Thus, gain (but not loss) will be recognized on the distribution of property other than the stock or securities in the controlled corporation in a transfer to which section 355 (or so much of section 356 as relates to section 355) applies. For this purpose, the gain recognition provisions of section 311(b) will not apply to the distribution of securities notwithstanding that the recipient may be taxed by reason of the excess principal amount rule of section 355(a)(3)(A), but the gain recognition rule will apply to stock which is not permitted to be received tax-free under section 355(a).

5. Golden parachutes (sec. 118(d)(5)-(7) of the bill, sec. 1804(j) of the Reform Act, and sec. 280G of the Code)

Present Law

Under present law, no deduction is allowed for "excess parachute payments" (sec. 280G) and a nondeductible 20-percent excise tax is imposed on the recipient of any excess parachute payment (sec. 4999).

---

[3] These amendments are not intended to affect the treatment of any income from the discharge of indebtedness arising in connection with a corporate reorganization.

The term parachute payment does not include any payment made to (or for the benefit of) a disqualified individual (1) with respect to a corporation that was, immediately before the change in control, a small business corporation (as defined in sec. 1361(b), relating to S corporations) or (2) with respect to a corporation no stock of which was, immediately before the change in control, readily tradable on an established securities market, or otherwise, provided shareholder approval was obtained with respect to the payment to a disqualified individual.

The Secretary may, by regulations, provide that a corporation fails to meet the requirement that it have no stock that is readily tradable if a substantial portion of the assets of any entity consists (either directly or indirectly) of stock in the corporation and interests in the entity are readily tradable on an established securities market, or otherwise.

Congress was concerned that, absent specific rules, a taxpayer might utilize the exemption for shareholder approval to avoid the golden parachute provisons by creating tiers of entities. Such avoidance is possible if the gross value of the entity-shareholder's interest in the corporation constitutes a substantial portion of such entity's assets. Congress contemplated that, in such cases, the Secretary will adopt regulations requiring approval of the owners of the entity rather than the approval of the entity itself. Of course, such shareholder approval may be obtained only if the entity shareholder also has no stock that is readily tradable.

The Secretary is authorized to prescribe such regulations as may be necessary or appropriate to carry out the purposes of the golden parachute provisions.

Explanation of Provision

Under present law, a corporation could fail to qualify for the shareholder approval exception if it has nonvoting preferred stock that is publicly traded, even if all common stock of the corporation is not publicly traded. In some cases, an interest in preferred stock is more in the nature of debt rather than equity. The purpose of the golden parachute provisions is to protect equity shareholders whose interest in the corporation could be impaired by parachute payments to disqualified individuals. No protection is necessary in the case of nonvoting preferred stock if the preferred shareholders receive the redemption or liquidation value to which they are entitled.

Thus, the bill provides that, for purposes of the shareholder approval requirements, the term "stock" does not include any stock (1) that is not entitled to vote, (2) that is limited and preferred as to dividends and does not participate in corporate growth to any significant extent, (3) that has redemption and liquidation rights which do not exceed the issue price of such stock (except for a reasonable redemption or liquidation premium), (4) that is not convertible into another class of stock, and (5) the rights of which are not adversely affected by the parachute payments.

The bill addresses several issues that arise in the application of the shareholder approval requirements for a corporation the stock of which is not publicly traded by expanding the Secretary's regulatory authority under the golden parachute provisions. It is expected that regulations will address these issues, particularly the application of the shareholder approval requirements in the case of shareholders that are not individuals (i.e., the shareholders are partnerships, corporations, or other nonindividual entities), and to what extent nonvoting interests in the entity shareholder have the right to affect the approval of that shareholder. In general, it is anticipated that the normal voting rights of the entity shareholder will determine whether or not the entity shareholder approves the parachute payments. For example, limited partners with no right to vote on partnership issues generally would not be entitled to vote with respect to the partnership shareholder's approval of a parachute payment.

The bill specifically authorizes the Secretary to prescribe regulations addressing the application of the shareholder approval requirements to entity shareholders that hold de minimis amounts of stock in the corporation. Of course, shareholder approval would still be required if the corporation constituted a substantial portion of the assets of the entity shareholder.

For purposes of the small business exception, the bill provides that "small business corporation" is defined as in section 1361(b) but without regard to paragraph (1)(C) thereof (relating to nonresident aliens). In the golden parachute context, the effect of the use of the small business corporation definition was to treat domestic corporations less favorably to the extent they were owned by foreign persons rather than U.S. persons. Because less favorable treatment was accorded to these corporations solely because they were owned by foreign persons (as contrasted to U.S. corporations whose shareholders were not taxable by the United States), this golden parachute provision discriminated against foreign persons and would have violated certain U.S. treaties.

6. Settlement funds (sec. 118(e) of the bill, sec. 1807(a)(7) of the Reform Act, and sec. 468B of the Code)

Present Law

A taxpayer generally may deduct qualified payments to a designated settlement fund at the time such payments are made. A qualified payment does not include any amount which may be transferred from a designated settlement fund to the taxpayer. The taxpayer may not hold a beneficial interest in the income or corpus of the fund.

Explanation of Provision

The bill clarifies that a qualified payment does not include any amount which may be transferred from a designated settlement fund to any person related to the taxpayer.

The bill also clarifies that a designated settlement fund (1) must extinguish completely the taxpayer's tort liability with respect to a class of claimants, and (2) must not under its terms provide a beneficial interest in the income or corpus of the fund to any person related to the taxpayer.

7. Treatment of stripped tax-exempt bonds (sec. 118(p)(4) of the bill, sec. 1879 of the Reform Act, and sec. 1286(d) of the Code)

Present Law

In determining the basis of a stripped coupon or stripped bond relating to a tax-exempt obligation under present law, the holder makes adjustments to basis to account for the accrual of original issue discount ("OID"). The total adjustment to basis on account of OID is an amount not in excess of that amount which produces a yield to maturity equal to the lower of (1) the coupon rate on the tax-exempt obligation, or (2) the yield to maturity of the stripped coupon or stripped bond.

Explanation of Provision

Under the bill, in the case of a tax-exempt obligation from which one or more coupons have been stripped, a portion of OID with respect to any stripped coupon or stripped bond (as determined under the general coupon stripping rules) is treated as OID on a tax-exempt obligation. OID in excess of the "tax-exempt portion" is treated as OID on an obligation that is not a tax-exempt obligation.

Under the bill, the tax-exempt portion of the OID with respect to a stripped coupon or stripped bond relating to a tax-exempt obligation is the excess of the stated redemption price at maturity (or in the case of a coupon, the amount payable on the due date of the coupon), over an issue price that would produce a yield to maturity as of the purchase date (of the stripped coupon or stripped bond) equal to the lower of (1) the coupon rate on the tax-exempt obligation from which the coupons were separated, or (2) the yield to maturity (on the basis of the purchase price) of the stripped coupon or stripped bond. The taxpayer can elect to use the original yield to maturity instead of the coupon rate for these purposes.

For example, assume that a tax-exempt obligation with a face amount of $100 due January 1, 1990, and with a coupon rate of 10 percent (compounded semiannually) is issued for $100 on January 1, 1987, and is stripped on January 1, 1988. The right to receive the principal amount is sold for $79.21 reflecting a yield to maturity at the time of the strip of 12 percent (compounded semiannually). Under the bill, the tax-exempt portion of discount on the stripped bond is limited to $17.73, the difference between the stated redemption price ($100) and the issue price that would produce a yield to maturity of 10 percent ($82.27). This portion of the discount is treated as OID on a tax-exempt obligation.

The amount of discount on the stripper bond in excess of the tax-exempt portion is $3.06, equal to the excess of total discount ($20.79) over the tax-exempt portion. This portion of the discount is treated as OID with respect to an obligation that is not a tax-exempt obligation.

The total amount of OID allocable to the accrued period ending on July 1, 1988, with respect to the stripped-bond is $4.75 (6 percent of $79.21), of which $4.11 is treated as OID on a tax-exempt obligation (5 percent of $82.27) and $0.64 ($4.75 minus $4.11) is treated as OID on an obligation that is not a tax-exempt obligation. The holder's basis for the bond is increased to $83.96 ($79.21 issue price plus accrued discount of $4.75).

The provision is effective for any purchase or sale of a stripped coupon or stripped bond relating to a tax-exempt obligation after June 10, 1987. Present law remains in effect for any purchase or sale of any such stripped coupon or bond after October 21, 1986, and before June 11, 1987. Present law also remains in effect in the case of any person who, on June 10, 1987, held for sale in the ordinary course of such person's trade or business any obligation or coupon in stripped form, with respect to any sale of such obligation or coupon by such person, and with respect to any such obligation or coupon while held by another person who purchased such obligation from the person who held such obligation or coupon on June 10, 1987.

8. Reorganizations of investment companies (sec. 118(o)(5) of the bill, sec. 1879 of the Reform Act, and sec. 368 of the Code)

Present Law

The Act provided that stock of a RIC, REIT, or diversified investment company will not be treated as stock of a single issuer for purposes of determining whether the holder is diversified within the meaning of section 368(a)(2)(F)(ii). The legislative history of that amendment provided that the provision was intended to permit an investment company to be treated as a diversified investment company only if it would be so defined if it were deemed to own its ratable share of the assets of any RIC, REIT, or diversified investment company in which it owns stock (without regard to whether its percentage ownership is 50 percent or more).

Explanation of Provision

The bill conforms the statutory language to the legislative history of the Act. The bill provides that, for purposes of determining whether a corporation is diversified, a person holding stock in a RIC, REIT, or diversified investment company shall, except as otherwise provided in regulations, be treated as holding its proportionate share of the assets held by the RIC, REIT, or diversified investment company. It is anticipated, for example, that the regulations may provide for exceptions in de minimis cases.

9. Elimination of duplicative Medicare tax provisions for certain State and local government employees (sec. 118(o) of the bill, sec. 1895 of the Reform Act, and sec. 3121(u) of the Code)

Present Law

Under Code section 1402(c), certain employees of State or local governments who are compensated solely on a fee basis are subject to the self-employment (SECA) tax, including the Medicare portion of that tax. The Consolidated Omnibus Budget Reconciliation Act of 1985 (P.L. 99-272) extended Medicare coverage and tax to State and local government employees hired after 1985, effective for service performed after March 31, 1986 (Code sec. 3121(u)). No exception was provided for certain State and local government employees who were already subject to Medicare tax under section 1402(c).

Explanation of Provision

The bill provides an exception to the Medicare tax provision in Code section 3121(u) for individuals holding a position described in section 1402(c)(2)(E), effective for services performed after March 31, 1986.

TITLE II. TECHNICAL CORRECTIONS TO OTHER TAX LEGISLATION

A. The Superfund Revenue Act of 1986 (Sec. 201 of the Bill)

1. Tax on chemical feedstocks (sec. 201(a) of the bill, sec. 513 of the Superfund Act, and sec. 4662 of the Code)

Present Law

Under present law, tax is imposed on the sale (by the manufacturer, producer, or importer) of 42 organic and inorganic chemical feedstocks. If the manufacturer, producer, or importer of a taxable chemical feedstock uses the feedstock, then tax is imposed on the use of the feedstock in the same manner as if the feedstock had been sold.

Under the "mixed stream" rule, no tax is imposed on the sale or use of any taxable organic chemical while such chemical is part of an intermediate hydrocarbon stream containing a mixture of taxable organic chemicals. Where tax is not imposed by reason of the mixed stream rule, the subsequent isolation, extraction, or removal of a taxable chemical from an intermediate hydrocarbon stream is treated as a taxable use.

A credit or refund (without interest) may be allowed or made to the taxpayer for tax paid with respect to a taxable chemical feedstock which is (1) exported, or (2) used to make a listed taxable substance which is exported. No credit or refund is allowed unless the person who paid the tax either has agreed to repay the tax to the exporter, or has obtained the written consent of the exporter waiving such repayment.

Explanation of Provisions

Refunds directly to exporter

Under the bill, the Secretary is required to issue regulations providing the conditions under which credit or refund (without interest) may be allowed or made to the exporter of a taxable chemical or listed taxable substance, rather than to the person who paid the tax, where the taxpayer waives his right to receive the refund and the exporter provides such information as may be required by the Secretary. Such conditions may include (1) a requirement that the exporter and the person who paid the tax register with the Internal Revenue Service, (2) a requirement that the exporter provide written evidence that the taxpayer has waived its right to the refund, and (3) the time, place, and manner in which claims for refund or credit are to be made.

Mixed stream rule

The bill clarifies that the present law treatment of intermediate hydrocarbon streams applies where the stream contains one or more taxable organic chemical feedstocks and one or more nontaxable organic chemicals. Thus the mixed stream rule is not limited to mixtures containing two or more taxable organic chemical feedstocks. The term "intermediate hydrocarbon stream" generally means a mixture of organic chemicals which is subject to further distillation or processing in the manufacture of a taxable chemical.

2. Broadbase environmental tax (sec. 201(b) of the bill, sec. 516 of the Superfund Act, and secs. 59A and 882 of the Code)

Present Law

Under present law, an environmental tax is imposed on corporations equal to 0.12 percent on the excess of modified alternative minimum taxable income ("AMTI") for the taxable year over $2 million. Modified AMTI means AMTI as defined for purposes of the corporate alternative minimum tax without regard to the alternative net operating loss and environmental tax deductions.

Although regulated investment corporations ("RICs") and real estate investment trusts ("REITs") are passive investment entities, they are classified as corporations and may have corporate alternative minimum taxable income.

Explanation of Provisions

RICs and REITs

The bill clarifies that the environmental tax does not apply to RICs and REITs.

Foreign corporations

The bill clarifies that a foreign corporation engaged in a trade or business within the United States is subject to the environmental tax on its income which is effectively connected with the conduct of a trade or business within the United States.

3. Leaking Underground Storage Tank Trust Fund tax (sec. 201(c) of the bill, sec. 521 of the Superfund Act, and secs. 4041, 4042, and 4081 of the Code)

Present Law

Under present law, an additional 0.1 cent per gallon tax is imposed on gasoline, diesel, special motor fuels, and other liquid fuels that are otherwise subject to fuels excise taxes. This tax also is imposed on any liquid used, or sold for use, as a fuel in a diesel-powered train. Revenues from this tax are used to finance the Leaking Underground Storage Tank ("LUST") Trust Fund. The additional tax generally is imposed on the same tax base and is collected in the same manner as the other excise taxes on these fuels (Code secs. 4041, 4042, and 4081). The tax is not imposed on liquified petroleum gas.

Explanation of Provisions

Tax on diesel fuel may be imposed on sale to retailer

The bill clarifies that the 0.1 cent per gallon LUST tax on diesel fuel is imposed upon sale to a qualified retailer in situations where the tax on diesel fuel for highway vehicle use is imposed on such sale.

Liquids used in aviation

The bill clarifies that the 0.1 cent per gallon LUST tax applies to all liquids used, or sold for use, as fuel in an aircraft, but that the LUST tax is not to be imposed twice (i.e., by reason of both sections 4041 and 4081). The bill also clarifies that the additional tax imposed by section 4041(c) on gasoline used as a fuel in noncommercial aviation is computed without regard to the LUST tax, and thus is not reduced by the LUST tax.

Exempt sales

The bill clarifies that gasoline which is used as a fuel in an aircraft or in a train is not exempt from the LUST tax by reason of section 6421 (relating to off-highway business use and sales of gasoline for certain other exempt purposes).

Floor stock tax

The bill clarifies that certain gasoline which on January 1, 1988 is held by a dealer is to be subject to a floor stocks tax at a rate of 9.1 cents rather than 9 cents per gallon. This ensures that the 0.1 cent per gallon LUST tax is collected on such gasoline. The revenue attributable to the additional floor stock tax is to be transferred to the Leaking Underground Storage Tank Trust Fund. The bill further clarifies that the penalty and other provisions of law applicable to section 4081 taxes also apply to the floor stock tax.

B. The Harbor Maintenance Revenue Act of 1986 (Sec. 202 of the Bill)

1. Tax rate for fuel used on inland waterways (sec. 202(a) of the bill, sec. 1404(a) of the Harbor Revenue Act, and sec. 4042(b) of the Code)

Present Law

The Superfund Revenue Act of 1986 (P.L. 99-499), as enacted on October 17, 1986, imposed an additional, separate "Leaking Underground Storage Tank Trust Fund financing rate" of 0.1 cent per gallon on fuel subject to the existing inland waterways fuel tax (Code sec. 4042). The Harbor Maintenance Revenue Act of 1986 (P.L. 99-662), enacted on November 17, 1986, amended section 4042 to provide a gradual increase in the rate of waterways fuel tax, the revenues from which are transferred to the Inland Waterways Trust Fund. In restating the increased tax rates in section 4042(b), this subsequent amendment failed to include the 0.1 cent per gallon additional tax rate (for the Leaking Underground Storage Tank Trust Fund) that had been enacted the previous month.

Explanation of Provision

The bill provides that for purposes of Code section 4042 (inland waterways fuel tax), the amendment made by the Superfund Revenue Act of 1986 relating to the separate 0.1 cent per gallon tax for the Leaking Underground Storage Tank Trust Fund is to be treated as enacted after the amendment to section 4042 made by the Harbor Maintenance Revenue Act of 1986.

The bill therefore reinstates the separate 0.1 cent per gallon tax rate (in sec. 4042) for the Leaking Underground Storage Tank Trust Fund, as if included in the Harbor Maintenance Revenue Act of 1986. Thus, the additional 0.1 cent per gallon fuel tax is effective as of January 1, 1987, i.e., the effective date for such tax as enacted in the Superfund Revenue Act.

2. Exemption from the harbor maintenance tax for cargo transported between U.S. possessions, etc. (sec. 202(b) of the bill, sec. 1402(a) of the Harbor Revenue Act, and sec. 4462(b) of the Code)

Present Law

A new harbor maintenance tax (Code secs. 4461-4462) was imposed under the Harbor Maintenance Revenue Act of 1986 (P.L. 99-662), effective April 1, 1987. The tax is 0.04 percent of the value of commercial cargo loaded or unloaded at U.S. ports.

Under section 4462(b), the tax does not apply to (1) cargo loaded on a vessel in a U.S. mainland port for transportation to Alaska, Hawaii, or a U.S. possession for ultimate use or consumption therein; (2) cargo loaded on a vessel in Alaska, Hawaii, or a U.S. possession for transportation to the U.S. mainland for ultimate use or consumption therein; (3) unloading of such cargo (described in (1) or (2), above) in Alaska, Hawaii, or any U.S. possession or in the U.S. mainland, respectively; or (4) cargo loaded on a vessel in Alaska, Hawaii, or a U.S. possession and unloaded in the State or possession in which loaded. The exception does not apply to crude oil cargo with respect to Alaska.

Explanation of Provision

The bill provides a specific exemption in section 4462(b)(1)(B) for cargo transported between U.S. possessions, between U.S. possessions and Alaska or Hawaii, and between Alaska and Hawaii. The amendment is effective as if included in the Harbor Maintenance Act of 1986 (i.e., as of April 1, 1987).

C. The Omnibus Budget Reconciliation Act of 1986 (Sec. 203 of the Bill)

1. Exclusion of discharge of indebtedness income in determining tax-exempt status of mutual or cooperative telephone and electric companies (sec. 203(a) of the bill, sec. 1011(a) of the Omnibus Budget Reconciliation Act of 1986, sec. 623 of Public Law 99-591, and sec. 512(c)(12)(A) of the Code)

Present Law

Under present law, benevolent life insurance associations of a purely local character, mutual ditch or irrigation companies, mutual or cooperative telephone companies, or like organizations are exempt Federal income tax (other than on unrelated business taxable income) so long as 85 percent or more of the income of the organization consists of amounts collected from members for the sole purpose of meeting losses and expenses (Code sec. 501(c)(12)). In the case of mutual or cooperative telephone companies, the 85-percent test is determined without regard to income received or accrued from (1) nonmember telephone companies for the performance of communication services with members, (2) certain pole rentals, and (3) the sale of display listing in a directory furnished to members. In the case of mutual or cooperative electric companies, the 85-percent test is determined without regard to income received or accrued from certain pole rentals.

Also under present law, gross income includes "income from discharge of indebtedness" (sec. 61(a)(12)). A discharge of indebtedness is considered to occur whenever a taxpayer's debt is forgiven, cancelled, or otherwise discharged by a payment of less than the principal amount of the debt. The amount of the indebtedness discharged is equal to the difference between the face amount of the debt, adjusted for any unamortized premium or discount, and any consideration given by the taxpayer to effect the discharge.

Section 1011(a) of the Omnibus Budget Reconciliation Act of 1986 and section 623 of Public Law 99-591 provided that certain loans made pursuant to sections 306A, 306B, or 311 of the Rural Electrification Act of 1936 could be prepaid at an amount less than the principal amount of the debt.

Explanation of Provision

The bill provides that, in the case of mutual or cooperative telephone companies or electric companies, the 85-percent test of section 501(c)(12) is to be determined without regard to any income from discharge of indebtedness arising from the prepayment of a loan under section 306A, 306B, or 311 of the Rural Electrification Act of 1936, as in effect of January 1, 1987.

2. Payment period for excise taxes on imported beverages and tobacco products (sec. 203(b) of the bill, sec. 8011 of the Omnibus Budget Reconciliation Act of 1986, and secs. 5061 and 5073 of the Code)

Present Law

The excise taxes on alcoholic beverages and tobacco products are imposed on removal of a taxable product from bonded premises. Tax on domestically produced articles (and distilled spirits imported in bulk) is paid with respect to semi-monthly periods, with tax being due 14 days after the close of each semi-monthly period. Tax on imported products (other than distilled spirits imported in bulk) is due 14 days after the date on which the taxable product enters the customs territory of the United States.

Explanation of Provision

The bill conforms the payment periods for excise taxes imposed on imported alcoholic beverages and tobacco products generally to those presently applicable to domestic products. Thus, tax on these imported products will be paid with respect to semi-monthly periods, with tax being due 14 days after the close of each semi-monthly period.

○